



### Test your understanding 9 – Tahoe

San Fran is a company that has issued a public bond. It reports to its shareholders on a bi-annual basis.

Tahoe, a company which holds financial assets until maturity, is one of many investors in San Fran's bond. On purchase, Tahoe deemed the bond to have a low credit risk due to San Fran's strong capacity to fulfil its short-term obligations. It was perceived, however, that adverse changes in the economic environment could have a detrimental impact on San Fran's liquidity.

At Tahoe's reporting date, it has access to the following information about San Fran:

- Sales have declined 15% over the past 6 months
- External agencies are reviewing its credit rating, but no changes have yet been made
- Although market bond prices have remained static, San Fran's bond price has fallen dramatically.

#### Required:

**Discuss the accounting treatment of the bond in Tahoe's financial statements at the reporting date.**

### Measuring expected losses

An entity's estimate of expected credit losses should be:

- unbiased and probability-weighted
- reflective of the time value of money
- based on information about past events, current conditions and forecasts of future economic conditions.

An entity may use convenient and practical measures when measuring expected credit losses if they are consistent with the above. IFRS 9 gives the example of calculating expected credit losses on trade receivables using a provision matrix. A provision matrix might specify fixed rates depending on the number of days that a trade receivable is overdue (for example, 2 per cent if not overdue, 3 per cent if less than 30 days overdue, 4 per cent if more than 30 days but less than 90 days past overdue, 25 per cent if 90–180 days past overdue). This is allowed if the reporting entity bases the matrix on historical default rates, as well as observable data about current market conditions and forecasts of future conditions.



### Test your understanding 10 – Janne

Janne's trade receivables are short-term and do not contain a significant financing component. Using historical observed default rates, updated for changes in forward-looking estimates, Janne estimates the following default rates for its trade receivables that are outstanding as at 31 May 20X3:

	<b>Not overdue</b>	<b>1–30 days overdue</b>	<b>31–60 days overdue</b>	<b>61+ days overdue</b>
Default rate	0.5%	1.5%	6.1%	16.5%

The trade receivables of Janne as at 31 May 20X3, the reporting date, are as follows:

	<b>Gross carrying amount (\$m)</b>
Not overdue	10.1
1 – 30 days overdue	4.3
31 – 60 days overdue	1.6
61 + days overdue	1.0

There is a loss allowance brought forward from the previous financial year of \$0.2 million in respect of trade receivables.

#### Required:

**Discuss the accounting treatment of the allowance in Janne's financial statements for the year ended 31 May 20X3.**

If an asset is credit impaired at the reporting date, IFRS 9 says that the expected credit losses should be measured as the difference between the asset's gross carrying amount and the present value of the estimated future cash flows when discounted at the original effective rate of interest.

IFRS 9 says that the following events may suggest the asset is credit-impaired:

- significant financial difficulty of the issuer or the borrower
- a breach of contract, such as a default
- the borrower being granted concessions
- it becoming probable that the borrower will enter bankruptcy.

If an asset is credit-impaired, interest income is calculated on the asset's net carrying amount (i.e. the gross carrying amount less the loss allowance).



### Test your understanding 11 – Napa

On 1 January 20X1, Napa purchased a bond for \$1 million which is measured at amortised cost. Interest of 10% is payable in arrears. Repayment is due on 31 December 20X3. The effective rate of interest is 10%.

On 31 December 20X1, Napa received interest of \$100,000. It estimated that the probability of default on the bond within the next 12 months would be 0.5%. If default occurs within the next 12 months then Napa estimated that no further interest will be received and that only 50% of the capital will be repaid on 31 December 20X3.

The asset's credit risk at 31 December 20X1 is low.

#### Required:

**Discuss the accounting treatment of the financial asset at 31 December 20X1.**



### Test your understanding 12 – Eve

On 1 February 20X6, Eve made a four-year loan of \$10,000 to Fern. The coupon rate on the loan is 6%, the same as the effective rate of interest. Interest is received at the end of each year.

On 1 February 20X9, Fern tells Eve that it is in significant financial difficulties. At this time the current market interest rate is 8%.

Eve estimates that it will receive no more interest from Fern. It also estimates that only \$6,000 of the capital will be repaid on the redemption date.

Eve has already recognised a loss allowance of \$1,000 in respect of its loan to Fern.

#### Required:

**How should this be accounted for?**

### Purchased or originated credit-impaired financial asset

A purchased or originated credit-impaired financial asset is one that is credit-impaired on initial recognition. Interest income is calculated on such assets using the **credit-adjusted effective interest rate**.

The credit adjusted effective interest rate incorporates all the contractual terms of the financial asset as well as expected credit losses. In other words, the higher the expected credit losses, the lower the credit adjusted effective interest rate.

Since credit losses anticipated at inception will be recognised through the credit-adjusted effective interest rate, the loss allowance on purchased or originated credit-impaired financial assets should be measured only as the **change in the lifetime expected credit losses** since initial recognition.

### Debt instruments at fair value through other comprehensive income

These assets are held at fair value at the reporting date and therefore the loss allowance should not reduce the carrying amount of the asset in the statement of financial position. Instead, the allowance is recorded against other comprehensive income.



#### Test your understanding 13 – FVOCI and expected losses

An entity purchases a debt instrument for \$1,000 on 1 January 20X1. The interest rate on the bond is the same as the effective rate. After accounting for interest for the year to 31 December 20X1, the carrying amount of the bond is still \$1,000.

At the reporting date of 31 December 20X1, the fair value of the instrument has fallen to \$950. There has not been a significant increase in credit risk since inception so expected credit losses should be measured at 12-month expected credit losses. This is deemed to amount to \$30.

#### Required:

**Explain how the revaluation and impairment of the financial asset should be accounted for.**

### Simplifications

IFRS 9 permits some simplifications:

- The loss allowance should always be measured at an amount equal to lifetime credit losses for trade receivables and contract assets (recognised in accordance with IFRS 15 *Revenue from Contracts with Customers*) if they do not have a significant financing component.
- For lease receivables, as well as trade receivables and contract assets with a significant financing component, the entity can choose as its accounting policy to measure the loss allowance at an amount equal to lifetime credit losses.

### Impairment reversals

At each reporting date, the loss allowance is recalculated.

It may be that the allowance was previously equal to lifetime credit losses but now, due to reductions in credit risk, only needs to be equal to 12-month expected credit losses. As such, there may be a substantial reduction in the allowance required.

Gains or losses on remeasurement of the loss allowance are recorded in profit or loss.



## 9 Derecognition of financial instruments



### The Conceptual Framework

According to the *Conceptual Framework*, derecognition normally occurs when the entity:

- loses control of the asset, or
- has no present obligation for the liability.

Accounting for derecognition should faithfully represent the changes in an entity's net assets, as well as any assets or liabilities retained.

This is achieved by:

- derecognising any transferred, expired or consumed component, and
- recognising a gain or loss on the above, and
- recognising any retained component.

Sometimes an entity might appear to have transferred an asset or liability. However, derecognition would not be appropriate if exposure to variations in the element's economic benefits is retained.

As you will see below, IFRS 9 *Financial Instruments* is consistent with the *Conceptual Framework* with regards to the issue of derecognition.

A **financial asset** should be derecognised if one of the following has occurred:

- The contractual rights have expired (for example, an option held by the entity has lapsed and become worthless)
- The financial asset has been sold and substantially all the risks and rewards of ownership have been transferred from the seller to the buyer.

The analysis of where the risks and rewards of ownership lie after a transaction is critical. If an entity has retained substantially all of the risks and rewards of a financial asset then it should not be derecognised, even if it has been legally 'sold' to another entity.

A **financial liability** should be derecognised when the obligation is discharged, cancelled or expires.

The accounting treatment of derecognition is as follows:

- The difference between the carrying amount of the asset or liability and the amount received or paid for it should be recognised in profit or loss for the period.
- For investments in equity instruments held at fair value through other comprehensive income, the cumulative gains and losses recognised in other comprehensive income **are not** reclassified to profit or loss on disposal.
- For investments in debt instruments held at fair value through other comprehensive income, the cumulative gains and losses recognised in other comprehensive income **are** reclassified to profit or loss on disposal.



#### Test your understanding 14 – Ming

Ming has two receivables that it has factored to a bank in return for immediate cash proceeds. Both receivables are due from long standing customers who are expected to pay in full and on time. Ming had agreed a three-month credit period with both customers.

The first receivable is for \$200,000. In return for assigning the receivable, Ming has received \$180,000 from the factor. Under the terms of the factoring arrangement, Ming will not have to repay this money, even if the customer does not settle the debt (the factoring arrangement is said to be 'without recourse').

The second receivable is for \$100,000. In return for assigning the receivable, Ming has received \$70,000 from the factor. The terms of this factoring arrangement state that Ming will receive a further \$5,000 if the customer settles the account on time.

If the customer does not settle the account in accordance with the agreed terms then the receivable will be reassigned back to Ming who will then be obliged to refund the factor with the original \$70,000 (this factoring arrangement is said to be 'with recourse').

**Required:**

**Discuss the accounting treatment of the two factoring arrangements.**



#### Test your understanding 15 – Case

Case holds equity investments at fair value through profit or loss. Due to short-term cash flow shortages, Case sold some equity investments for \$5 million when the carrying amount was \$4 million. The terms of the disposal state that Case has the right to repurchase the shares at any point over the next two years at their fair value on the repurchase date. Case has not derecognised the investment because its directors believe that a repurchase is highly likely.

**Required:**

**Advise the directors of Case as to the acceptability of the above accounting treatment.**



### Test your understanding 16 – Jones

Jones bought an investment in equity shares for \$40 million plus associated transaction costs of \$1 million. The asset was designated upon initial recognition as fair value through other comprehensive income. At the reporting date the fair value of the financial asset had risen to \$60 million. Shortly after the reporting date the financial asset was sold for \$70 million.

#### Required:

- (a) **How should the investment be accounted for?**
- (b) **How would the answer have been different if the investment had been classified to be measured at fair value through profit and loss?**

## 10 Derivatives

### Definitions



IFRS 9 says that a derivative is a financial instrument with the following characteristics:

- (a) Its value changes in response to the change in a specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, a credit rating or credit index or similar variable (called the 'underlying').
- (b) It requires little or no initial net investment relative to other types of contract that have a similar response to changes in market conditions.
- (c) It is settled at a future date.

A contract to buy or sell a non-financial item (such as inventory or property, plant and equipment) is only a derivative if:

- it can be settled net in cash (or using another financial asset), and
- the contract was not entered into for the purpose of receipt or delivery of the item to meet the entity's operating requirements.

IFRS 9 says that a contract to buy or sell a non-financial item is considered to be settled net in cash when:

- the terms of the contract permit either party to settle the contract net
- the entity has a practice of settling similar contracts net
- the entity, for similar contracts, has a practice of taking delivery of the item and then quickly selling it in order to benefit from fair value changes
- the non-financial item is readily convertible to cash.

If the contract is not a derivative then it is a simple executory contract. Such contracts are not normally accounted for until the sale or purchase date.



### The *Conceptual Framework*

The *Conceptual Framework* defines an executory contract as a contract that is equally unperformed. This might mean that neither party to the contract has fulfilled any of its obligations.

An example would be a contract to pay employees \$10 for every hour that they work. If the employee has not yet worked any hours then the entity has no obligation to pay the employee.

Executory contracts are not normally recognised in financial statements unless they are onerous, in which case a provision would be recognised in accordance with IAS 37 *Provisions, Contingent Assets and Contingent Liabilities*.

## Common derivatives

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### Forward contracts

The holder of a forward contract is obliged to buy or sell a defined amount of a specific underlying asset, at a specified price at a specified future date.

### Futures contracts

Futures contracts oblige the holder to buy or sell a standard quantity of a specific underlying item at a specified future date.

Futures contracts are very similar to forward contracts. The difference is that futures contracts have standard terms and are traded on a financial exchange, whereas forward contracts are tailor-made and are not traded on a financial exchange.

### Swaps

Two parties agree to exchange periodic payments at specified intervals over a specified time period. For example, in an interest rate swap, the parties may agree to exchange fixed and floating rate interest payments calculated by reference to a notional principal amount.

### Options

These give the holder the right, but not the obligation, to buy or sell a specific underlying asset on or before a specified future date.

## Measurement of derivatives

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On initial recognition, derivatives should be measured at fair value. Transaction costs are expensed to the statement of profit or loss.

At the reporting date, derivatives are remeasured to fair value. Movements in fair value are recognised in profit or loss.



### Accounting for derivatives

Entity A has a reporting date of 30 September. It enters into an option on 1 June 20X5, to purchase 10,000 shares in another entity on 1 November 20X5 for \$10 per share. The purchase price of each option is \$1. This is recorded as follows:

Debit	Option (10,000 × \$1)	\$10,000
Credit	Cash	\$10,000

By 30 September the fair value of each option has increased to \$1.30. This increase is recorded as follows:

Debit	Option (10,000 × (\$1.30 – \$1))	\$3,000
Credit	Profit or loss	\$3,000

On 1 November, the fair value per option increases to \$1.50. The share price on the same date is \$11.50. A exercises the option on 1 November and the shares are classified at fair value through profit or loss. Financial assets are recognised at fair value so the shares are initially measured at \$115,000 (10,000 × \$11.50):

Debit	Investment in shares (at fair value)	\$115,000
Credit	Cash (10,000 × \$10)	\$100,000
Credit	Option (\$10,000 + \$3,000)	\$13,000
Credit	Profit or loss (gain on option)	\$2,000



### Test your understanding 17 – Hoggard

Hoggard buys 100 options on 1 January 20X6 for \$5 per option. Each option gives Hoggard the right to buy a share in Rowling on 31 December 20X6 for \$10 per share.

**Required:**

**How should this be accounted for, given the following outcomes?**

- The options are sold on 1 July 20X6 for \$15 each.
- On 31 December 20X6, Rowling's share price is \$8 and Hoggard lets the option lapse unexercised.
- The option is exercised on 31 December when Rowling's share price is \$25. The shares are classified as held for trading.





## 11 Embedded derivatives

### Definition

An embedded derivative is a **'component of a hybrid contract that also includes a non-derivative host, with the effect that some of the cash flows of the combined instrument vary in a way similar to a standalone derivative'** (IFRS 9, para 4.3.3).

### Accounting treatment

With regards to the accounting treatment of an embedded derivative, if the host contract is within the scope of IFRS 9 then the entire contract must be classified and measured in accordance with that standard.

If the host contract is not within the scope of IFRS 9 (i.e. it is not a financial asset or liability), then the embedded derivative can be separated out and measured at fair value through profit or loss if:

- (i) **'the economic risks and characteristics of the embedded derivative are not closely related to those of the host contract**
- (ii) **a separate instrument with the same terms as the embedded derivative would meet the definition of a derivative, and**
- (iii) **the entire instrument is not measured at fair value with changes in fair value recognised in profit or loss'** (IFRS 9, para 4.3.3).

Because of the complexity involved in splitting out and measuring an embedded derivative, IFRS 9 permits a hybrid contract where the host element is outside the scope of IFRS 9 to be measured at fair value through profit or loss in its entirety.

For the vast majority of embedded derivatives, the whole contract will simply be measured at fair value through profit or loss.



#### An investment in a convertible bond

An entity has an investment in a convertible bond, which can be converted into a fixed number of equity shares at a specified future date. The bond is a non-derivative host contract and the option to convert to shares is therefore a derivative element.

The host contract, the bond, is a financial asset and so is within the scope of IFRS 9. This means that the rules of IFRS 9 must be applied to the entire contract.

The bond would fail the contractual cash flow characteristics test and therefore the entire contract should be measured at fair value through profit or loss.

## 12 Hedge accounting



### Investor perspective – derivatives

An entity has inventories of gold that cost \$8m and whose value has increased to \$10m. The entity is worried that the fair value of this inventory will fall, so it enters into a futures contract on 1 October 20X1 to sell the inventory for \$10m in 6 months' time.

By the reporting date, the fair value of the inventory had fallen by \$1m to \$9m. There was a \$1m increase in the fair value of the derivative.

In accordance with IFRS 9, the \$1m gain on the derivative will be recognised through profit or loss:

Dr Derivative	\$1m
Cr Profit or loss	\$1m

In accordance with IAS 2, the \$1m decline in the inventory's fair value will not be recognised because inventories are measured at the lower of cost (\$8m) and NRV (\$9m, assuming no selling costs).

The derivative has created volatility in profit or loss, which will also make 'earnings per share' volatile. Potential investors may be deterred by this, because they may assume that their dividend receipts will also be volatile. Although some investors are risk-seeking, others prefer steady and predictable returns.

If the entity had chosen to apply hedge accounting, this volatility would have been eliminated. This section of the text will outline the criteria for, and accounting treatment of, hedge accounting in more detail.



### Definitions

**Hedge accounting** is a method of managing risk by designating one or more hedging instruments so that their change in fair value is offset, in whole or in part, by the change in fair value or cash flows of a hedged item.

A **hedged item** is an asset or liability that exposes the entity to risks of changes in fair value or future cash flows (and is designated as being hedged). There are 3 types of hedged item:

- A recognised asset or liability
- An unrecognised firm commitment – a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date
- A highly probable forecast transaction – an uncommitted but anticipated future transaction.

A **hedging instrument** is a designated derivative, or a non-derivative financial asset or financial liability, whose fair value or cash flows are expected to offset changes in fair value or future cash flows of the hedged item.



### Types of hedge accounting

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IFRS 9 identifies three types of hedge. Two of these are in the SBR syllabus:

- 1 **'Fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment that is attributable to a particular risk and could affect profit or loss (or other comprehensive income for equity investments measured at fair value through other comprehensive income).**
- 2 **Cash flow hedge: a hedge of the exposure to variability in cash flows that is attributable to a particular risk associated with a recognised asset or liability or a highly probable forecast transaction and that could affect profit or loss' (IFRS 9, para 6.5.2).**

### Criteria for hedge accounting

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Under IFRS 9, hedge accounting rules can only be applied if the hedging relationship meets the following criteria:

- 1 The hedging relationship consists only of eligible hedging instruments and hedged items.
- 2 At the inception of the hedge there must be formal documentation identifying the hedged item and the hedging instrument.
- 3 The hedging relationship meets all effectiveness requirements (see latter section for more details).



### Accounting treatment of a fair value hedge

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At the reporting date:

- The hedging instrument will be remeasured to fair value
- The carrying amount of the hedged item will be adjusted for the change in fair value since the inception of the hedge.

The gain (or loss) on the hedging instrument and the loss (or gain) on the hedged item will be recorded:

- in profit or loss in most cases, but
- in other comprehensive income if the hedged item is an investment in equity that is measured at fair value through other comprehensive income.



### Investor perspective – hedge accounting

An entity has inventories of gold that cost \$8m but whose value has increased to \$10m. The entity is worried that the fair value of this inventory will fall, so it enters into a futures contract on 1 October 20X1 to sell the inventory for \$10m in 6 months' time. This was designated as a fair value hedge.

By the reporting date of 31 December 20X1, the fair value of the inventory had fallen from \$10m to \$9m. There was a \$1m increase in the fair value of the derivative.

The entity believes that all effectiveness criteria have been met.

Under a fair value hedge, the movement in the fair value of the item and instrument since the inception of the hedge are accounted for. The gains and losses will be recorded in profit or loss.

The \$1 m gain on the future and the \$1m loss on the inventory will be accounted for as follows:

Dr Derivative	\$1m
Cr Profit or loss	\$1m
Dr Profit or loss	\$1m
Cr Inventory	\$1m

By applying hedge accounting, the profit impact of remeasuring the derivative to fair value has been offset by the movement in the fair value of the inventory. Volatility in profits and 'earnings per share' has, in this example, been eliminated. This may make the entity look less risky to current and potential investors.

Note that the inventory will now be held at \$7m (cost of \$8m – \$1m fair value decline). This is neither cost nor NRV. The normal accounting treatment of inventory has been changed by applying hedge accounting rules.



### Test your understanding 18 – Fair value hedge

On 1 January 20X8 an entity purchased equity instruments for their fair value of \$900,000. They were designated upon initial recognition to be classified as fair value through other comprehensive income.

At 30 September 20X8, the equity instrument was still worth \$900,000 but the entity became worried about the risk of a decline in value. It therefore entered into a futures contract to sell the shares for \$900,000 in six months' time. It identified the futures contract as a hedging instrument as part of a fair value hedging arrangement. The fair value hedge was correctly documented and designated upon initial recognition. All effectiveness criteria have been complied with.

By the reporting date of 31 December 20X8, the fair value of the equity instrument had fallen to \$800,000, and the fair value of the futures contract had risen by \$90,000.

**Required:**

**Explain the accounting treatment of the fair value hedge arrangement based upon the available information.**



### Test your understanding 19 – Firm commitments

Chive has a firm commitment to buy an item of machinery for CU2m on 31 March 20X2. The Directors are worried about the risk of exchange rate fluctuations.

On 1 October 20X1, when the exchange rate is CU2:\$1, Chive enters into a futures contract to buy CU2m for \$1m on 31 March 20X2.

At 31 December 20X1, CU2m would cost \$1,100,000. The fair value of the futures contract has risen to \$95,000. All effectiveness criteria have been complied with.

**Required:**

**Explain the accounting treatment of the above in the financial statements for the year ended 31 December 20X1 if:**

- (a) **Hedge accounting was not used.**
- (b) **On 1 October 20X1, the futures contract was designated as a fair value hedge of the movements in the fair value of the firm commitment to purchase the machine.**





### Accounting treatment of a cash flow hedge

For cash flow hedges, the hedging instrument will be remeasured to fair value at the reporting date. The gain or loss is recognised in other comprehensive income.

However, if the gain or loss on the hedging instrument since the inception of the hedge is greater than the loss or gain on the hedged item then the **excess** gain or loss on the instrument must be recognised in profit or loss.



#### Test your understanding 20 – Cash flow hedge

A company enters into a derivative contract in order to protect its future cash inflows relating to a recognised financial asset. At inception, when the fair value of the hedging instrument was nil, the relationship was documented as a cash flow hedge.

By the reporting date, the loss in respect of the future cash flows amounted to \$9,100 in fair value terms. It has been determined that the hedging relationship meets all effectiveness criteria.

#### Required:

**Explain the accounting treatment of the cash flow hedge if the fair value of the hedging instrument at the reporting date is:**

- (a) \$8,500
- (b) \$10,000.

If the hedged item eventually results in the recognition of a financial asset or a financial liability, the gains or losses that were recognised in equity shall be reclassified to profit or loss as a reclassification adjustment in the same period during which the hedged forecast cash flows affect profit or loss (e.g. in the period when the hedged forecast sale occurs).

If the hedged item eventually results in the recognition of a non-financial asset or liability, the gain or loss held in equity must be adjusted against the carrying amount of the non-financial asset/liability. This is not a reclassification adjustment and therefore it does not affect other comprehensive income.



### Test your understanding 21 – Bling

On 31 October 20X1, Bling had inventories of gold which cost \$6.4m to buy and which could be sold for \$7.7m. The management of Bling are concerned about the risk of fluctuations in future cash inflows from the sale of this gold.

To mitigate this risk, Bling entered into a futures contract on 31 October 20X1 to sell the gold for \$7.7m. The contracts mature on 31 March 20X2. The hedging relationship was designated and documented at inception as a cash flow hedge. All effectiveness criteria are complied with.

On 31 December 20X1, the fair value of the gold was \$8.6m. The fair value of the futures contract had fallen by \$0.9m.

There is no change in fair value of the gold and the futures contract between 31 December 20X1 and 31 March 20X2. On 31 March 20X2, the inventory is sold for its fair value and the futures contract is settled net with the bank.

#### Required:

- (a) **Discuss the accounting treatment of the hedge in the year ended 31 December 20X1.**
- (b) **Outline the accounting treatment of the inventory sale and the futures contract settlement on 31 March 20X2.**



### Test your understanding 22 – Grayton

In January, Grayton, whose functional currency is the dollar (\$), decided that it was highly probable that it would buy an item of plant in one year's time for KR 200,000. As a result of being risk averse, it wished to hedge the risk that the cost of buying KR would rise and so entered into a forward rate agreement to buy KR 200,000 in one year's time for the fixed sum of \$100,000. The fair value of this contract at inception was zero and it was designated as a hedging instrument.

At Grayton's reporting date of 31 July, the KR had depreciated and the value of KR 200,000 was \$90,000. The fair value of the derivative had declined by \$10,000. These values remained unchanged until the plant was purchased.

#### Required:

**How should this be accounted for?**

## Hedge effectiveness

Hedge accounting can only be used if the hedging relationship meets all effectiveness requirements. In the examples so far, it has been assumed that this is the case.

According to IFRS 9, an entity must assess at the inception of the hedging relationship, and at each reporting date, whether a hedging relationship meets the hedge effectiveness requirements. The assessment should be **forward-looking**.

The hedge effectiveness requirements are as follows

- 1 **'There must be an economic relationship between the hedged item and the hedging instrument'** (IFRS 9, para 6.4.1).
  - For example, if the price of a share falls below \$10, the fair value of a futures contract to sell the share for \$10 rises.
- 2 **'The effect of credit risk does not dominate the value changes that result from that economic relationship'** (IFRS 9, para 6.4.1).
  - Credit risk may lead to erratic fair value movements in either the hedged item or the hedging instrument. For example, if the counterparty of a derivative experiences a decline in credit worthiness, the fair value of the derivative (the hedging instrument) may fall substantially. This movement is unrelated to changes in the fair value of the item and would lead to hedge ineffectiveness.
- 3 **'The hedge ratio of the hedging relationship is the same as that resulting from the quantity of the hedged item that the entity actually hedges and the quantity of the hedging instrument that the entity actually uses to hedge that quantity of hedged item'** (IFRS 9, para 6.4.1).



### Hedge ratios

An entity owns 120,000 gallons of oil. It enters into 1 futures contract to sell 40,000 gallons of oil at a fixed price.

It wishes to designate this as a fair value hedge, with 120,000 gallons of oil as the hedged item and the futures contract as the hedging instrument. If deemed effective, this would mean that the fair value gain or loss on the hedged item (the oil) and the fair value loss or gain on the hedging instrument (the futures contract) would be recorded and recognised in profit or loss.

However, the hedge ratio means that the gain or loss on the item would probably be much bigger than the loss or gain on the instrument. This would create volatility in profit or loss that is at odds with the purpose of hedge accounting. Therefore, the hedge ratio must be adjusted to avoid the imbalance.

It may be that the hedged item should be designated as 40,000 gallons of oil, with the hedging instrument as 1 futures contract. The other 80,000 gallons of oil would be accounted for in accordance with normal accounting rules (IAS 2 *Inventories*).

### Rebalancing

Many hedging relationships involve basis risk – the risk that the gain or loss on the item will not offset the loss or gain on the instrument. Sometimes this risk is significant.

Some airline companies hedge their exposure to rising fuel costs by entering into futures contracts to buy crude oil. Although crude oil is a component of airplane fuel, there are other components and factors that affect the cost of the fuel. It may be that, by the reporting date, the fair value of the hedged item (the fuel) has moved by considerably more than the fair value of the hedging instrument (the futures contracts).

In the case of the airline, it may be that they enter into additional futures contracts to mitigate their risk exposure. As such, the hedge ratio has changed. In order to comply with the effectiveness requirements, and therefore to continue applying hedge accounting rules, the airline must rebalance the designated quantities of the hedged item and the hedging instrument.

### Discontinuing hedge accounting

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An entity must cease hedge accounting if any of the following occur:

- The hedging instrument expires or is exercised, sold or terminated.
- The hedge no longer meets the hedging criteria.
- A forecast future transaction that qualified as a hedged item is no longer highly probable.

The discontinuance should be accounted for prospectively (entries posted to date are not reversed).

Upon discontinuing a cash flow hedge, the treatment of the accumulated gains or losses on the hedging instrument within reserves depends on the reason for the discontinuation. IFRS 9 says:

- If the forecast transaction is no longer expected to occur, gains and losses recognised in other comprehensive income must be taken to profit or loss immediately.
- If the transaction is still expected to occur, the gains and losses will be retained in equity until the former hedged transaction occurs.

### 13 Disclosure of financial instruments

IFRS 7 *Financial Instruments: Disclosures* provides the disclosure requirements for financial instruments.

The main disclosures required are:

- 1 Information about the significance of financial instruments for an entity's financial position and performance.
- 2 Information about the nature and extent of risks arising from financial instruments.

#### Significance of financial instruments

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- An entity must disclose the **significance** of financial instruments for their financial position and performance. The disclosures must be made for each class of financial instruments.
- An entity must disclose items of income, expense, gains, and losses, with separate disclosure of gains and losses from each class of financial instrument.



## Nature and extent of risks arising from financial instruments

### Qualitative disclosures

The qualitative disclosures describe:

- risk exposures for each type of financial instrument
- management's objectives, policies, and processes for managing those risks
- changes from the prior period.

### Quantitative disclosures

The quantitative disclosures provide information about the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel. These disclosures include:

- summary quantitative data about exposure to each risk at the reporting date
- disclosures about credit risk, liquidity risk, and market risk
- concentrations of risk.



### Test your understanding 23 – Lizzer

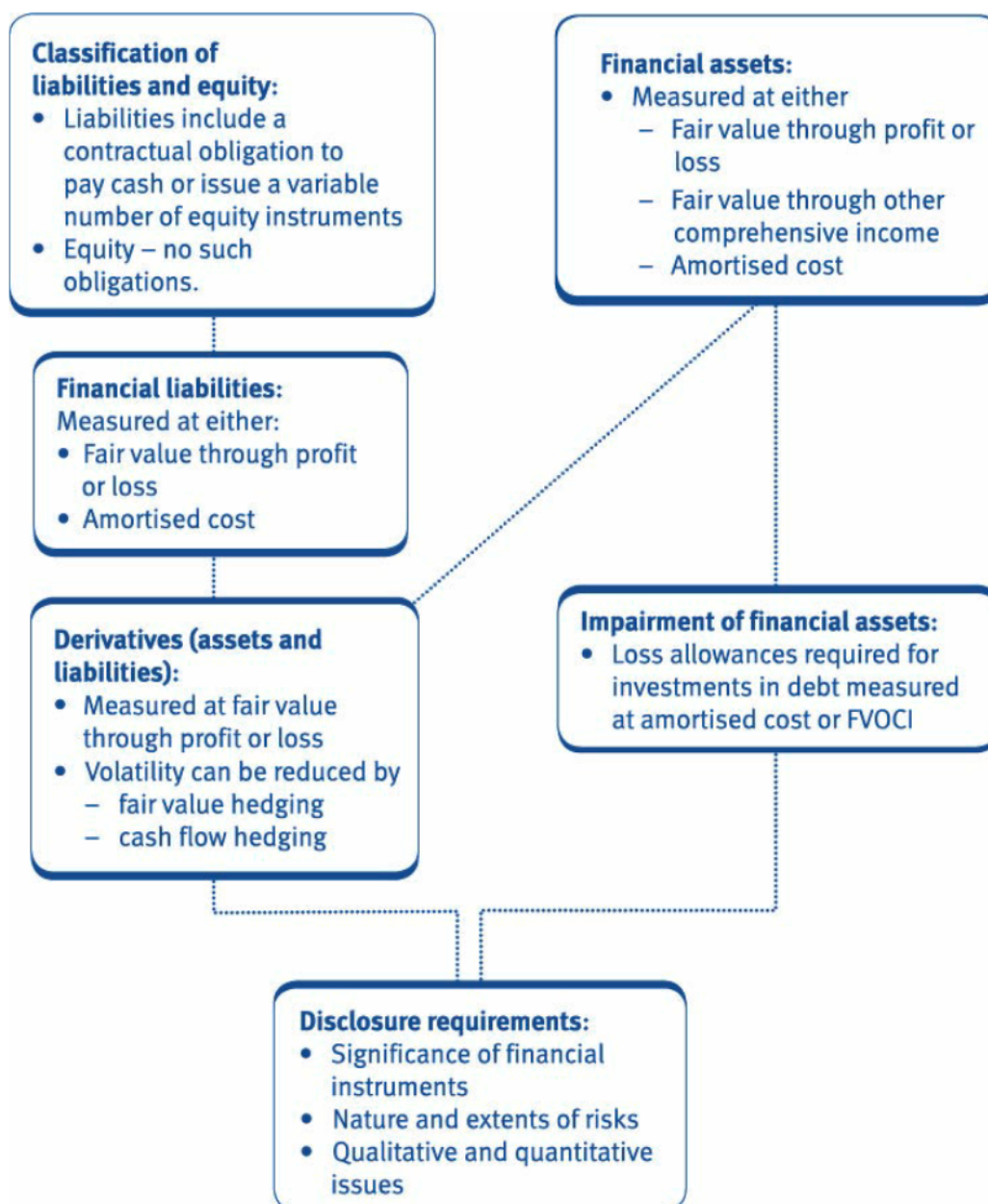
Lizzer is a debt issuer whose business is the securitisation of a portfolio of underlying investments and financing their purchase through the issuing of listed, limited recourse debt. The repayment of the debt is dependent upon the performance of the underlying investments. Debt-holders bear the ultimate risks and rewards of ownership of the underlying investments. Given the debt specific nature of the underlying investments, the risk profile of individual debt may differ.

Lizzer does not consider its debt-holders as being amongst the primary users of the financial statements and, accordingly, does not wish to provide disclosure of the debt-holders' exposure to risks in the financial statements, as distinct from the risks faced by the company's shareholders, in accordance with IFRS 7 *Financial Instruments: Disclosures*.

#### Required:

**Discuss the directors' view that no further information regarding the above should be disclosed in the financial statements because it would be 'excessive'.**

## 14 Chapter summary



## Test your understanding answers

**Test your understanding 1 – Liabilities or equity?****1m preference shares**

The definition of a financial liability includes any contract that may be settled in a variable number of the entity's own equity instruments.

Therefore, a contract that requires the entity to deliver as many of the entity's own equity instruments as are equal in value to a certain amount should be treated as debt.

Coasters must redeem the first set of preference shares by issuing ordinary shares equal to the value of \$3 million. The \$3 million received from the preference share issue should be classified as a liability on the statement of financial position.

**2m preference shares**

A contract that will be settled by the entity delivering a fixed number of its own equity instruments is an equity instrument.

Coasters will redeem the second preference share issue with a fixed number of ordinary shares. Therefore, the \$5.6 million from the second preference share issue should be classified as equity in the statement of financial position.

**4m preference shares**

A financial liability exists if there is a contractual obligation to deliver cash or another financial asset.

There is no obligation for Coasters to repay the instrument.

Dividends are only payable if they are also paid on ordinary shares. There is no obligation to pay dividends on ordinary shares so there is no obligation to pay dividends on these preference shares.

The instrument is not a financial liability. The proceeds from the preference share issue should therefore be classified as equity in the statement of financial position.



### Test your understanding 2 – Hoy

**Hoy** has a financial liability to be measured at amortised cost.

The financial liability is initially recorded at the fair value of the consideration received (the net proceeds of issue). This amount is then increased each year by interest at the effective rate and reduced by the actual repayments.

Hoy has no issue costs, so the net proceeds of issue were \$9,500 (\$10,000 less 5%). The annual cash payment is \$200 (the 2% coupon rate multiplied by the \$10,000 nominal value of the debt).

	Bal b/fwd	Finance costs (10%)	Cash paid	Bal c/fwd
	\$	\$	\$	\$
31 Dec X1	9,500	950	(200)	10,250
31 Dec X2	10,250	1,025	(200)	
			(11,075)	
		<u>1,975</u>		

**Wiggins** has a liability that will be classified and accounted for at amortised cost and thus initially measured at the fair value of consideration received less the transaction costs:

	\$
Cash received (\$20,000 × 90%)	18,000
Less the transaction costs	(1,000)
	<u>17,000</u>
Initial recognition	

The effective rate is used to determine the finance cost for the year – this is charged to profit or loss. The coupon rate is applied to the nominal value of the loan notes to determine the cash paid to the holder of the loan notes:

	Bal b/fwd	Finance costs (12%)	Cash paid	Bal c/fwd
	\$	\$	\$	\$
31 Dec X4	17,000	2,040	(1,200)	17,840
31 Dec X5	17,840	2,141	(1,200)	18,781
31 Dec X6	18,781	2,254	(1,200)	19,835
31 Dec X7	19,835	2,380	(1,200)	
			(21,015)	
		<u>8,815</u>		

**Cavendish** has a financial liability to be measured at amortised cost.

It is initially recorded at the fair value of the consideration received. There is no discount on issue, nor is there any issue costs to deduct from the initial measurement.

The opening balance is increased each year by interest at the effective rate. The liability is reduced by the cash repayments – there are no interest repayments in this example because it is a zero rate bond.

	<b>Bal b/fwd</b>	<b>Finance costs (7%)</b>	<b>Cash paid</b>	<b>Bal c/fwd</b>
	\$	\$	\$	\$
31 Dec X5	10,000	700	Nil	10,700
31 Dec X6	10,700	749	(11,449)	



### Test your understanding 3 – Bean

When a financial liability is designated to be measured at fair value through profit or loss to reduce an accounting mis-match, the fair value movement must be split into:

- fair value movement due to own credit risk, which is presented in other comprehensive income (OCI)
- the remaining fair value movement, which is presented in profit or loss.

The value of Bean's liability will be reduced by \$30 million. A credit of \$10 million will be recorded in OCI and a credit of \$20 million will be recorded in profit or loss.





### Test your understanding 4 – Craig

Up to 31 December 20X8, the accounting entries are the same under both scenarios.

#### 1 Splitting the proceeds

The cash payments on the bond should be discounted to their present value using the interest rate for a bond without the conversion rights, i.e. 8%.

Date		Cash flow	Discount factor (8%)	Present value
		\$		\$
31/12/X6	Interest	4,000	1/1.08	3,704
31/12/X7	Interest	4,000	1/1.08 <sup>2</sup>	3,429
31/12/X8	Interest and principal	104,000	1/1.08 <sup>3</sup>	82,559
	Liability component		A	89,692
	Net proceeds of issue were		B	100,000
	Equity component		B – A	10,308

#### 2 The annual finance costs and year end carrying amounts

	Opening balance	Finance cost (8%)	Cash paid	Closing balance
	\$	\$	\$	\$
X6	89,692	7,175	(4,000)	92,867
X7	92,867	7,429	(4,000)	96,296
X8	96,296	7,704	(4,000)	100,000

#### 3 (a) Conversion

The carrying amounts at 31 December 20X8 are:

	\$
Equity	10,308
Liability – bond	100,000
	<hr/>
	110,308
	<hr/>

If the conversion rights are exercised, then 50,000 (\$100,000 ÷ 2) equity shares of \$1 are issued and \$60,308 is classified as share premium.

#### (b) Redemption

The carrying amounts at 31 December 20X8 are the same as under 3a. On redemption, the \$100,000 liability is extinguished by cash payments. The equity component remains within equity, probably as a non-distributable reserve.



### Test your understanding 5 – Americano

Equity investments can be measured at fair value through other comprehensive income if the investment is not held for short-term trading and if an irrevocable designation has been made. If equity investments are acquired for short-term trading then IFRS 9 *Financial Instruments* stipulates that they must be measured at fair value through profit or loss. Therefore, Americano should measure its investments in equity instruments at fair value through profit or loss.

Directors are appointed by shareholders and have a responsibility to act in their best interests and this may be considered to be by maximising profits. However, at the same time, accountants are trusted by the public to produce financial statements that faithfully represent the financial performance, position and cash flows of an entity. These financial statements are relied on by users to make economic decisions. To ensure that this trust is not broken, accountants are bound by a *Code of Ethics and Conduct*.

Integrity is defined as being honest and straight-forward. Manipulating financial asset measurement categories shows a lack of integrity.

It would appear that fair value through other comprehensive income has been selected as a way to produce a particular performance profile in profit or loss. This demonstrates a lack of objectivity.

Therefore, despite the director's claim about the impact on shareholder wealth, the directors have an ethical responsibility to faithfully represent Americano's underlying performance and position. This is achieved through compliance with IFRS Standards.



### Test your understanding 6 – Paloma

A debt instrument can be held at amortised cost if

- the entity intends to hold the financial asset to collect contractual cash flows, rather than selling it to realise fair value changes.
- the contractual cash flows of the asset are solely payments of principal and interest based upon the principal amount outstanding.

Paloma's objective is to hold the financial assets and collect the contractual cash flows. Making some sales when cash flow deteriorates does not contradict that objective.

The bond pays a market level of interest, and therefore the interest payments received provide adequate compensation for the time value of money or the credit risk associated with the principal amount outstanding.

This means that the asset can be measured at amortised cost.



### Test your understanding 7 – Tokyo

- (a) The business model is to hold the asset until redemption. Therefore, the debt instrument will be measured at amortised cost.

The asset is initially recognised at its fair value plus transaction costs of \$97,000 (\$95,000 + \$2,000).

Interest income will be recognised in profit or loss using the effective rate of interest.

	<b>Bfd</b>	<b>Interest (8%)</b>	<b>Receipt</b>	<b>Cfd</b>
	\$	\$	\$	\$
y/e 31/12/X1	97,000	7,760	(5,000)	99,760
y/e 31/12/X2	99,760	7,981	(5,000)	102,741
y/e 31/12/X3	102,741	8,219	(5,000)	nil
			(105,960)	

In the year ended 31 December 20X1, interest income of \$7,760 will be recognised in profit or loss and the asset will be held at \$99,760 on the statement of financial position.

In the year ended 31 December 20X2, interest income of \$7,981 will be recognised in profit or loss and the asset will be held at \$102,741 on the statement of financial position.

In the year ended 31 December 20X3, interest income of \$8,219 will be recognised in profit or loss.

- (b) The business model is to hold the asset until redemption, but sales may be made to invest in other assets will higher returns. Therefore, the debt instrument will be measured at fair value through other comprehensive income.

The asset is initially recognised at its fair value plus transaction costs of \$97,000 (\$95,000 + \$2,000).

Interest income will be recognised in profit or loss using the effective rate of interest.

The asset must be revalued to fair value at the year end. The gain will be recorded in other comprehensive income.

	<b>Bfd</b>	<b>Interest (per (a))</b>	<b>Receipt</b>	<b>Total</b>	<b>Gain/(loss)</b>	<b>Cfd</b>
	\$	\$	\$	\$	\$	\$
y/e 31/12/X1	97,000	7,760	(5,000)	99,760	10,240	110,000
y/e 31/12/X2	110,000	7,981	(5,000)	112,981	(8,981)	104,000
y/e 31/12/X3	104,000	8,219	(5,000)	1,259	(1,259)	nil
			(105,960)			

Note that the amounts recognised in profit or loss as interest income must be the same as if the asset was simply held at amortised cost. Therefore, the interest income figures are the same as in part (a).

In the year ended 31 December 20X1, interest income of \$7,760 will be recognised in profit or loss and a revaluation gain of \$10,240 will be recognised in other comprehensive income. The asset will be held at \$110,000 on the statement of financial position.

In the year ended 31 December 20X2, interest income of \$7,981 will be recognised in profit or loss and a revaluation loss of \$8,981 will be recognised in other comprehensive income. The asset will be held at \$104,000 on the statement of financial position.

In the year ended 31 December 20X3, interest income of \$8,219 will be recognised in profit or loss and a revaluation loss of \$1,259 will be recognised in other comprehensive income.

- (c) The bond would be classified as fair value through profit or loss.

The asset is initially recognised at its fair value of \$95,000. The transaction costs of \$2,000 would be expensed to profit or loss.

In the year ended 31/12/X1, interest income of \$5,000 ( $\$100,000 \times 5\%$ ) would be recognised in profit or loss. The asset would be revalued to \$110,000 with a gain of \$15,000 ( $\$110,000 - \$95,000$ ) recognised in profit or loss.

On 1/1/X2, the cash proceeds of \$110,000 would be recognised and the financial asset would be derecognised.



### Test your understanding 8 – Magpie

The loan is a financial asset because Magpie has a contractual right to receive cash in two years' time.

Financial assets are initially recognised at fair value. Fair value is the price paid in an orderly transaction between market participants at the measurement date.

Market participants would receive 8% interest on loans of this type, whereas the loan made to the supplier is interest-free. It would seem that the transaction has not occurred on fair value terms.

The financial asset will not be recognised at the price paid of \$2 million as this is not the fair value. Instead, the fair value must be determined. This can be achieved by calculating the present value of the future cash flows from the loan (discounted using a market rate of interest).

The financial asset will therefore be initially recognised at \$1.71 million ( $\$2\text{m} \times 1/1.08^2$ ). The entry required to record this is as follows:

Dr Financial asset	\$1.71m
Dr Profit or loss	\$0.29m
Cr Cash	\$2.00m

The financial asset is subsequently measured at amortised cost:

	1 Jan X1	Interest (8%)	Receipt	31 Dec X1
	\$m	\$m	\$m	\$m
y/e 31 /12/X1	1.71	0.14	–	1.85

Interest income of \$0.14 million is recorded by posting the following:

Dr Financial asset	\$0.14m
Cr Profit or loss	\$0.14m

The loan is interest-free, so no cash is received during the period.

The financial asset will have a carrying amount of \$1.85 million as at 31 December 20X1.

By 31 December 20X2, the financial asset will have a carrying amount of \$2 million. This amount will then be repaid by the supplier.





### Test your understanding 9 – Tahoe

Using available information, Tahoe needs to assess whether the credit risk on the bond has increased significantly since inception.

It would seem that San Fran's performance has declined and this may have an impact on its liquidity.

The review of San Fran's credit rating by external agencies is suggestive of wider concerns about the performance and position of San Fran.

The fact that market bond prices are static suggests that the decline in San Fran's bond price is entity specific. This is likely to be a response to San Fran's increased credit risk.

Based on the above, it would seem that the credit risk of the bond is no longer low. As a result, it can be concluded that credit risk has increased significantly since inception.

This means that Tahoe must recognise a loss allowance equal to lifetime expected credit losses on the bond.



### Test your understanding 10 – Janne

Trade receivables are financial assets and are normally measured at amortised cost in accordance with IFRS 9 *Financial Instruments*. A loss allowance is required for investments in debt instruments that are measured at amortised cost.

Janne's expected credit losses can be calculated by multiplying the carrying amount of its receivables with the expected risk of default over their life. Calculation of expected credit losses must use information about past events and current economic conditions as well as forecasts of future economic conditions and therefore Janne is correct to have adjusted its historical default rates for future estimates. Discounting will not be required as the receivables are short-term.

The lifetime expected credit losses on the trade receivables are:

	Lifetime expected credit losses
	\$m
Not overdue ( $\$10.1\text{m} \times 0.5\%$ )	0.05
1 – 30 days overdue ( $\$4.3\text{m} \times 1.5\%$ )	0.06
31 – 60 days overdue ( $\$1.6\text{m} \times 6.1\%$ )	0.10
More than 60 days overdue ( $\$1.0\text{m} \times 16.5\%$ )	0.17
	<hr/>
	0.38
	<hr/>

The allowance required is \$0.38 million. The current allowance of \$0.2 million must be increased by \$0.18 million. An expense of \$0.18 million is charged to the statement of profit or loss.



### Test your understanding 11 – Napa

The credit risk on the financial asset has not significantly increased. Therefore, a loss allowance should be made equal to 12-month expected credit losses. The loss allowance should factor in a range of possible outcomes, as well as the time value of money.

The credit loss on the asset is \$586,777 (W1). This represents the present value of the difference between the contractual cash flows and the expected receipts if a default occurs.

The expected credit loss is \$2,934 (\$586,777 credit loss  $\times$  0.5% probability of occurrence). A loss allowance of \$2,934 will be created and an impairment loss of \$2,934 will be charged to profit or loss in the year ended 31 December 20X1.

The net carrying amount of the financial asset on the statement of financial position is \$997,066 (\$1,000,000 – \$2,934).

Note: Interest in future periods will continue to be charged on the asset's gross carrying amount of \$1,000,000.

Date	Expected cash shortfall \$	Discount rate	PV \$
31/12/X2	100,000	1/1.1	90,909
31/12/X3	100,000	1/1.1 <sup>2</sup>	82,645
31/12/X3	500,000	1/1.1 <sup>2</sup>	413,223
			<hr/> 586,777 <hr/>



### Test your understanding 12 – Eve

Evidence about the significant financial difficulties of Fern mean that the asset is now credit impaired.

Expected losses on credit impaired assets are calculated as the difference between the asset's gross carrying amount and the present value of the expected future cash flows discounted using the original effective rate of interest.

Because the coupon and the effective interest rate are the same, the carrying amount of the asset will remain constant at \$10,000.

The present value of the future cash flows discounted using the original effective rate is \$5,660 (\$6,000  $\times$  1/1.06).

The expected losses are therefore \$4,340 (\$10,000 – \$5,660) and so a loss allowance should be recognised for this amount. Therefore, the existing loss allowance must be increased by \$3,340 (\$4,340 – \$1,000) with an expense charged to profit or loss.

The asset is credit impaired and so interest income will now be calculated on the net carrying amount of \$5,660 (the gross amount of \$10,000 less the loss allowance of \$4,340). Consequently, in the last year of the loan, interest income of \$340 ( $5,660 \times 6\%$ ) will be recognised in profit or loss.



### Test your understanding 13 – FVOCI and expected losses

A loss of \$50 (\$1,000 – \$950) arising on the revaluation of the asset to fair value will be recognised in other comprehensive income.

Dr OCI	\$50
Cr Financial asset	\$50

The 12-month expected credit losses of \$30 will be debited to profit or loss. The credit entry is not recorded against the carrying amount of the asset but rather against other comprehensive income:

Dr Impairment loss (P/L)	\$30
Cr OCI	\$30

There is therefore a cumulative loss in OCI of \$20 (the fair value change of \$50 offset by the impairment amount of \$30).



### Test your understanding 14 – Ming

The principle at stake with derecognition or otherwise of receivables is whether, under the factoring arrangement, the risks and rewards of ownership pass from Ming to the factor. The key risk with regard to receivables is the risk of bad debt.

In the first arrangement the \$180,000 has been received as a one-off, non-refundable sum. This is factoring without recourse for bad debts. The risk of bad debt has clearly passed from Ming to the factoring bank. Accordingly Ming should derecognise the receivable and there will be an expense of \$20,000 recognised.

In the second arrangement the \$70,000 is simply a payment on account. More may be received by Ming implying that Ming retains an element of reward. The monies received are refundable in the event of default and as such represent an obligation. This means that the risk of slow payment and bad debt remains with Ming who is liable to repay the monies so far received. Despite the passage of legal title the receivable should remain recognised in the accounts of Ming. In substance Ming has borrowed \$70,000 and this loan should be recognised immediately. This will increase the gearing of Ming.



### Test your understanding 15 – Case

An entity has transferred a financial asset if it has transferred the contractual rights to receive the cash flows of the asset.

IFRS 9 says that if an entity has transferred a financial asset, it must evaluate the extent to which it has retained the significant risks and rewards of ownership. If the entity transfers substantially all the risks and rewards of ownership, the entity must derecognise the financial asset.

Gains and losses on the disposal of a financial asset are recognised in the statement of profit or loss.

Case is under no obligation to buy back the shares and is therefore protected from future share price declines. Moreover, If Case does repurchase the shares, this will be at fair value rather than a pre-fixed price and therefore Case does not retain the risks and rewards related to price fluctuations.

The risks and rewards of ownership have been transferred and, as such, Case should derecognise the financial asset. A profit of \$1m (\$5m – \$4m) should be recognised in profit or loss.



### Test your understanding 16 – Jones

- (a) On purchase the investment is recorded at fair value. The asset is classified as fair value through other comprehensive income and, as such, transaction costs are included in the initial value:

Dr Asset	41m
Cr Cash	41m

At the reporting date the asset is remeasured to fair value and the gain of \$19 million (\$60m – \$41 m) is recognised in other comprehensive income and taken to equity:

Dr Asset	19m
Cr Other comprehensive income	19m

Prior to disposal, the asset is remeasured to fair value with the gain of \$10 million (\$70m – \$60m) recorded in other comprehensive income:

Dr Asset	10m
Cr Other comprehensive income	10m

The asset is then derecognised:

Dr Cash	70m
Cr Asset	70m

Note that any gains or losses recorded in OCI to-date are **not** reclassified to profit or loss upon derecognition of the financial asset, although they may be reclassified within equity.

- (b) If Jones had designated the investment as fair value through profit and loss, the transaction costs would have been recognised as an expense in profit or loss. The entry posted on the purchase date would have been:

Dr Asset	40m
Cr Cash	40m

Dr Profit or loss	1m
Cr Cash	1m

At the reporting date, the asset is remeasured to fair value and the gain of \$20 million (\$60m – \$40m) is recognised in the statement of profit or loss:

Dr Asset	20m
Cr Profit or loss	20m

On disposal the asset is derecognised and the profit on disposal is recorded in the statement of profit or loss:

Dr Cash	70m
Cr Asset	60m
Cr Profit or loss	10m



### Test your understanding 17 – Hoggard

In all scenarios the cost of the derivative on 1 January 20X6 is \$500 ( $\$5 \times 100$ ) and an asset is recognised in the statement of financial position.

Dr Asset – option	\$500
Cr Cash	\$500

#### Outcome A

If the option is sold for \$1,500 ( $100 \times \$15$ ) before the exercise date, it is derecognised at a profit of \$1,000.

Dr Cash	\$1,500
Cr Asset – option	\$500
Cr Profit or loss	\$1,000

#### Outcome B

If the option lapses unexercised, then it is derecognised and there is a loss to be taken to profit or loss:

Dr Profit or loss	\$500
Cr Asset – option	\$500



**Outcome C**

If the option is exercised then the option is derecognised, the entity records the cash paid upon exercise, and the investment in shares is recognised at fair value. An immediate profit is recognised:

Dr Asset – investment (100 × \$25)	\$2,500
Cr Cash (100 × \$10)	\$1,000
Cr Asset – option	\$500
Cr Profit or loss	\$1,000

**Test your understanding 18 – Fair value hedge**

The hedged item is an investment in equity that is measured at fair value through other comprehensive income (OCI). Therefore, the increase in the fair value of the derivative of \$90,000 and the fall in fair value of the equity interest of \$100,000 since the inception of the hedge are taken to OCI.

Dr Derivative	\$90,000
Cr OCI	\$90,000
Dr OCI	\$100,000
Cr Equity investment	\$100,000

The net result is a small loss of \$10,000 in OCI.

**Test your understanding 19 – Firm commitments**

- (a) The futures contract is a derivative and is measured at fair value with all movements being accounted for through profit or loss.

The fair value of the futures contract at 1 October 20X1 was nil. By the year end, it had risen to \$95,000. Therefore, at 31 December 20X1, Chive will recognise an asset at \$95,000 and a gain of \$95,000 will be recorded in profit or loss.

- (b) If the relationship had been designated as a fair value hedge then the movement in the fair value of the hedging instrument (the future) and the fair value of the hedged item (the firm commitment) since inception of the hedge are accounted for through profit or loss.

The derivative has increased in fair value from \$nil at 1 October 20X1 to \$95,000 at 31 December 20X1. Purchasing CU2 million at 31 December 20X1 would cost Chive \$100,000 more than it would have done at 1 October 20X1. Therefore the fair value of the firm commitment has fallen by \$100,000.

At year end, the derivative will be held at its fair value of \$95,000, and the gain of \$95,000 will be recorded in profit or loss.

The \$100,000 fall in the fair value of the commitment will also be accounted for, with an expense recognised in profit or loss.

In summary, the double entries are as follows:

Dr Derivative	\$95,000
Cr Profit or loss	\$95,000
Dr Profit or loss	\$100,000
Cr Firm commitment	\$100,000

The gain on the derivative and the loss on the firm commitment largely net off. There is a residual \$5,000 (\$100,000 – \$95,000) net expense in profit or loss due to hedge ineffectiveness.

Nonetheless, financial statement volatility is far less than if hedge accounting had not been used.



#### Test your understanding 20 – Cash flow hedge

- (a) The movement on the hedging instrument is less than the movement on the hedged item. Therefore, the instrument is remeasured to fair value and the gain is recognised in other comprehensive income.

Dr Derivative	\$8,500
Cr OCI	\$8,500

- (b) The movement on the hedging instrument is more than the movement on the hedged item. The excess movement of \$900 (\$10,000 – \$9,100) is recognised in the statement of profit or loss.

Dr Derivative	\$10,000
Cr Profit or loss	\$900
Cr OCI	\$9,100



### Test your understanding 21 – Bling

- (a) Between 1 October 20X1 and 31 December 20X1, the fair value of the futures contract had fallen by \$0.9m. Over the same time period, the hedged item (the estimated cash receipts from the sale of the inventory) had increased by \$0.9m (\$8.6m – \$7.7m).

Under a cash flow hedge, the movement in the fair value of the hedging instrument is accounted for through other comprehensive income. Therefore, the following entry is required:

Dr Other comprehensive income	\$0.9m
Cr Derivative	\$0.9m

The loss recorded in other comprehensive income will be held within equity.

- (b) The following entries are required:

Dr Cash	\$8.6m
Cr Revenue	\$8.6m
Dr Cost of sales	\$6.4m
Cr Inventory	\$6.4m

To record the sale of the inventory at fair value

Dr Derivative	\$0.9m
Cr Cash	\$0.9m

To record the settlement of the futures contract

Dr Profit or loss	\$0.9m
Cr OCI	\$0.9m

To reclassify the losses held in equity through profit or loss in the same period as the hedged item affects profit or loss.



### Test your understanding 22 – Grayton

The forward rate agreement has no fair value at its inception so is initially recorded at \$nil.

This is a cash flow hedge. The derivative has fallen in value by \$10,000 but the cash flows have increased in value by \$10,000 (it is now \$10,000 cheaper to buy the asset).

Because it has been designated a cash flow hedge, the movement in the value of the hedging instrument is recognised in other comprehensive income:

Dr Other comprehensive income	\$10,000
Cr Derivative	\$10,000

(Had this not been designated a hedging instrument, the loss would have been recognised immediately in profit or loss.)

The forward contract will be settled and closed when the asset is purchased.

Property, plant and equipment is a non-financial item. The loss on the hedging instrument held within equity is adjusted against the carrying amount of the plant.

The following entries would be posted:

Dr Liability – derivative	\$10,000
Dr Plant	\$90,000
Cr Cash	\$100,000

Being the settlement of the derivative and the purchase of the plant.

Dr Plant	\$10,000
Cr Cash flow hedge reserve	\$10,000

Being the adjustment of the losses held within equity against the carrying amount of the plant. Notice that the plant will be held at \$100,000 (\$90,000 + \$10,000) and the cash spent in total was \$100,000. This was the position that the derivative guaranteed.

**Test your understanding 23 – Lizzer**

Lizzer's perception of who could reasonably be considered to be among the users of its financial statements is too narrow, being limited to the company's shareholders rather than including debt-holders.

IAS 1 *Presentation of Financial Statements* states that the objective of financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. The standard also states that omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements.

The objective of IFRS 7 *Financial Instruments: Disclosures* is to require entities to provide disclosures in their financial statements that enable users to evaluate the significance of financial instruments for the entity's financial position and performance. IFRS 7 states that, amongst other matters, for each type of risk arising from financial instruments, an entity shall disclose:

- the exposures to risk and how they arise
- its objectives, policies and processes for managing the risk and the methods used to measure the risk.

Thus the risks attached to the debt should be disclosed.





## Tax

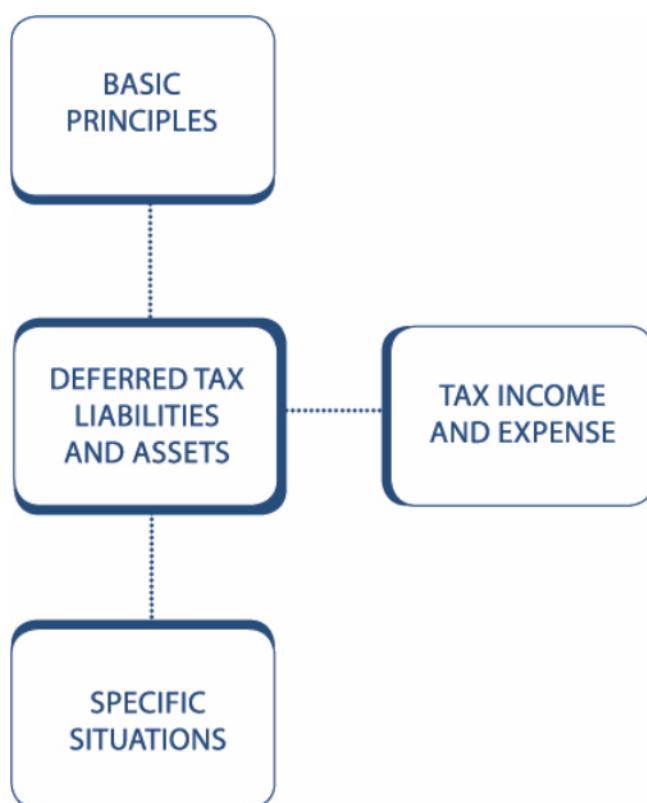
### Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss and apply the recognition and measurement of deferred tax liabilities and deferred tax assets
- Discuss and apply the recognition of current and deferred tax as income or expense
- Discuss and apply the treatment of deferred taxation on a business combination.



One of the PER performance objectives (PO6) is to record and process transactions and events. You need to use the right accounting treatments for transactions and events. These should be both historical and prospective – and include non-routine transactions. Working through this chapter should help you understand how to demonstrate that objective.



## 1 Basic principles of tax

### Taxation

Taxation is a major expense for businesses. IAS 12 *Income Taxes* notes that there are two elements to tax that an entity must deal with:

- **Current tax** – the amount payable to the tax authorities in relation to the trading activities of the current period.
- **Deferred tax** – an accounting measure used to match the tax effects of transactions with their accounting treatment. It is not a tax that is levied by the government that needs to be paid, but simply an application of the accruals concept.

In summary, the tax expense for an entity is calculated as follows:

Tax expense = current tax +/- movement in deferred tax



#### Progression

Some of the content of this chapter was tested in Financial Reporting. However, the situations you will encounter in the SBR exam will be more varied.

## 2 Current tax

### Accounting for current tax

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Current tax is the amount expected to be paid to the tax authorities by applying the tax laws and tax rates in place at the reporting date.

Current tax is recognised in the financial statements by posting the following entry:

Dr Tax expense (P/L)

Cr Tax payable (SFP)

Current tax accounting is often based on estimates, and the final amount payable might not be finalised until after the financial statements have been authorised for issue:

- If the eventual amount paid is less than the estimate recognised in the current period's financial statements then this will reduce the current tax expense in the next accounting period
- If the eventual amount paid is more than the estimate recognised in the current period's financial statements then this will increase the current tax expense in the next accounting period.

## 3 Basic principles of deferred tax

### The need to provide for deferred tax

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Differences between the principles in an accounting standard and the tax rules in a particular jurisdiction mean that accounting profits will not be the same as taxable profits.

Some of these differences are temporary:

- Property, plant and equipment might be written down at different rates for tax purposes than in the financial statements.
- Provisions might not be allowable for tax until the expenditure is incurred, but are recognised in the financial statements when there is a present obligation.

Some of these differences are not temporary:

- Fines are expensed to the statement of profit or loss, but are normally disallowed by the tax authorities.
- Client entertaining costs are expensed to the statement of profit or loss, but are normally disallowed by the tax authorities.

Temporary differences may mean that profits are reported in the financial statements before they are taxable by the authorities. Conversely, it might mean that tax is payable to the authorities even though profits have not yet been reported in the financial statements.

According to the accruals concept, the tax effect of a transaction should be reported in the same accounting period as the transaction itself. To ensure this, entities are required to account for deferred tax on temporary differences.



A **temporary difference** is the difference between the carrying amount of an asset or liability and its tax base.

The **tax base** is the '**amount attributed to an asset or liability for tax purposes**' (IAS 12, para 5).



#### Illustration 1 – Basic principles of deferred tax

Prudent prepares financial statements to 31 December each year. On 1 January 20X0, the entity purchased a non-current asset for \$1.6 million that had an anticipated useful life of four years. This asset qualified for immediate tax relief of 100% of the cost of the asset.

For the year ending 31 December 20X0, the draft accounts showed a profit before tax of \$2 million. The directors anticipate that this level of profit will be maintained for the foreseeable future.

Prudent pays tax at a rate of 30%. Apart from the differences caused by the purchase of the non-current asset in 20X0, there are no other differences between accounting profit and taxable profit or the tax base and carrying amount of net assets.

#### Required:

**Compute the pre, and post-tax profits for Prudent for each of the four years ending 31 December 20X0–20X3 inclusive and for the period as a whole assuming that:**

- (a) no deferred tax is recognised
- (b) deferred tax is recognised.





### Solution

#### (a) No deferred tax

First of all, it is necessary to compute the taxable profits of Prudent for each period and the current tax payable:

	Year ended 31 December				Total
	20X0	20X1	20X2	20X3	
	\$000	\$000	\$000	\$000	\$000
Accounting profit	2,000	2,000	2,000	2,000	8,000
Add back Depreciation	400	400	400	400	1,600
Deduct Capital allowances	(1,600)	—	—	—	(1,600)
Taxable profits	800	2,400	2,400	2,400	8,000
Current tax at 30%	240	720	720	720	2,400

The differences between the accounting profit and the taxable profit that occur from one year to another, cancel out over the four years as a whole.

The statements of profit or loss for each period and for the four years as a whole, are given below:

	Year ended 31 December				Total
	20X0	20X1	20X2	20X3	
	\$000	\$000	\$000	\$000	\$000
Profit before tax	2,000	2,000	2,000	2,000	8,000
Current tax	(240)	(720)	(720)	(720)	(2,400)
Profit after tax	1,760	1,280	1,280	1,280	5,600

Ignoring deferred tax produces a performance profile that suggests a declining performance between 20X0 and 20X1.

In fact the decline in profits is caused by the timing of the current tax charge on them.

In 20X0, some of the accounting profit escapes tax, but the tax is only postponed until 20X1, 20X2 and 20X3, when the taxable profit is more than the accounting profit.

**(b) Deferred tax is recognised**

The deferred tax figures that are required in the statement of financial position are given below:

	Year ended 31 December			
	20X0	20X1	20X2	20X3
	\$000	\$000	\$000	\$000
Carrying amount	1,200	800	400	Nil
Tax base	Nil	Nil	Nil	Nil
Temporary difference at year end	1,200	800	400	Nil
Closing deferred tax liability (30%)	360	240	120	Nil
Opening deferred tax liability	Nil	(360)	(240)	(120)
So charge/(credit) to P/L	360	(120)	(120)	(120)

The statements of profit or loss for the four year period including deferred tax are shown below:

	Year ended 31 December				Total
	20X0	20X1	20X2	20X3	
	\$000	\$000	\$000	\$000	\$000
Profit before tax	2,000	2,000	2,000	2,000	8,000
Current tax	(240)	(720)	(720)	(720)	(2,400)
Deferred tax	(360)	120	120	120	Nil
Profit after tax	1,400	1,400	1,400	1,400	5,600

A more meaningful performance profile is presented.

### Examples of temporary differences

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Temporary differences include (but are not restricted to):

- Tax deductions for items of property, plant and equipment that have a different pattern to the write-off of the asset in the financial statements.
- Intra-group profits in inventory that are unrealised for consolidation purposes yet taxable in the computation of the group entity that made the unrealised profit.
- Losses reported in the financial statements but the related tax relief is only available by carry forward against future taxable profits.
- Assets are revalued upwards in the financial statements, but no adjustment is made for tax purposes.
- Development costs are capitalised and amortised to profit or loss in future periods, but were deducted for tax purposes as incurred.
- The cost of granting share options to employees is recognised in profit or loss, but no tax deduction is obtained until the options are exercised.

## Calculating temporary differences

Deferred tax is calculated by comparing the carrying amount of an asset or liability to its tax base. The tax base is the amount attributed to the asset or liability for tax purposes. To assist with determining the tax base, IAS 12 notes that:

- 'The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. If those economic benefits will not be taxable, the tax base of the asset is equal to its carrying amount' (IAS 12, para 7).
- 'The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in future periods. In the case of revenue which is received in advance, the tax base of the liability is its carrying amount, less any amount of the revenue that will not be taxable in future periods' (IAS 12, para 8).



When looking at the difference between the carrying amount and the tax base of an asset or liability:

- If the carrying amount exceeds the tax base, the temporary difference is said to be a **taxable** temporary difference which will give rise to a deferred tax **liability**.
- If the tax base exceeds the carrying amount, the temporary difference is a **deductible** temporary difference which will give rise to a deferred tax **asset**.



### Test your understanding 1 – Dive (temporary differences)

An entity, Dive, provides the following information regarding its assets and liabilities as at 31 December 20X1.

	Carrying amount	Tax base	Temporary difference
<b>Assets</b>			
A machine cost \$100,000. Depreciation of \$18,000 has been charged to date. Tax allowances of \$30,000 have been claimed.			
Interest receivable in the statement of financial position is \$1,000. The interest will be taxed when received.			

Trade receivables have a carrying amount of \$10,000. The revenue has already been included in taxable profit.			
Inventory has been written down by \$500 to \$4,500 in the financial statements. The reduction is ignored for tax purposes until the inventory is sold.			
<b>Liabilities</b>			
Current liabilities include accrued expenses of \$1,000. This is deductible for tax on a cash paid basis.			
Accrued expenses have a carrying amount of \$5,000. The related expense has been deducted for tax purposes.			
<b>Required:</b> <b>Complete the table with carrying amount, tax base and temporary difference for each of the assets and liabilities.</b>			

## 4 Deferred tax liabilities and assets

### Recognition



IAS 12 *Income Taxes* states that deferred tax should be provided for on all taxable temporary differences, unless the deferred tax liability arises from:

- the initial recognition of goodwill, or
- the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction:
  - does not affect accounting profit or taxable profit, and
  - does not create equal taxable and deductible temporary differences.

Deferred tax assets should be recognised on all deductible temporary differences unless:

- the exceptions above apply
- insufficient taxable profits are expected to be available in the future against which the deductible temporary difference can be utilised.



### Recognition exemption – an example

On the reporting date, Enchilada purchases a factory building for \$1 million and recognises this as property, plant and equipment. In Enchilada's jurisdiction, the building is not deductible for tax. The tax rate is 20%.

The carrying amount of the asset is \$1 million. The tax base is nil because no tax deductions are permitted. As such, a taxable temporary difference of \$1 million arises.

Despite the fact that the factory building will generate taxable income of at least \$1 million (otherwise the asset's carrying amount is overstated) and thus a tax charge of at least \$0.2 million over its useful life, no deferred tax liability is recognised.

This is because the temporary difference arises from the initial recognition of an item that has not affected accounting profit (the asset was capitalised) or taxable profit (the asset is unrecognised for tax purposes) and the transaction has not created equal amounts of deductible and taxable temporary differences.

The logic behind this exemption is that recognition would not provide useful information. Think about the double entry:

Dr ??? \$0.2m

Cr Deferred tax liability \$0.2m

The debit cannot be posted to profit or loss or OCI because the transaction itself has not affected those statements. To-date the transaction has been recorded in PPE, but debiting PPE with a further \$0.2 million would make little sense and would reduce the understandability of financial statements.



### Measurement

The tax rate in force (or expected to be in force) when the asset is realised or the liability is settled, should be applied to the temporary difference to calculate the deferred tax balance. IAS 12 specifies that this rate must be based on legislation enacted or substantively enacted by the reporting date.

Deferred tax assets and liabilities are **not** discounted to present value.

The entry to profit or loss and other comprehensive income in respect of deferred tax is the difference between the net liability (or asset) at the beginning of the year and the net liability (or asset) at the end of the year. It is important to note that:

- If the item giving rise to the deferred tax is dealt with in profit or loss, the related deferred tax should also be presented in profit or loss.
- If the item giving rise to the deferred tax is dealt with in other comprehensive income, the related deferred tax should also be recorded in other comprehensive income and held within equity.



## Presentation

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Deferred tax liabilities and assets are presented as non-current on the statement of financial position.

IAS 12 notes that deferred tax assets and liabilities can be offset as long as:

- the entity has a legally enforceable right to set off **current** tax assets and **current** tax liabilities
- the deferred tax assets and liabilities relate to tax levied by the same tax authority.



### Test your understanding 2 – Dive (deferred tax calculation)

**Required:**

Using the information in 'test your understanding 1', calculate Dive's deferred tax balance as at 31 December 20X1. The applicable tax rate is 30%.



### Test your understanding 3 – Brick

Brick is a company with a reporting date of 30 April 20X4. The company obtains tax relief for research and development expenditure on a cash paid basis. The recognition of a material development asset during the year, in accordance with IAS 38, created a significant taxable temporary difference as at 30 April 20X4.

The tax rate for companies as at the reporting period was 22%. On 6 June 20X4, the government passed legislation to lower the company tax rate to 20% from 1 January 20X5.

**Required:**

**Explain which tax rate should have been used to calculate the deferred tax liability for inclusion in the financial statements for the year ended 30 April 20X4.**

## 5 Specific situations

### Revaluations

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Deferred tax should be recognised on the revaluation of property, plant and equipment even if:

- there is no intention to sell the asset
- any tax due on the gain made on any sale of the asset can be deferred by being 'rolled over' against the cost of a replacement asset.

Revaluation gains are recorded in other comprehensive income and so any deferred tax arising on the revaluation must also be recorded in other comprehensive income.



#### Test your understanding 4 – Dodge

An entity, Dodge, owns property, plant and equipment that cost \$100,000 when purchased. Depreciation of \$40,000 has been charged up to the reporting date of 31 March 20X1. The entity has claimed total tax allowances on the asset of \$50,000. On 31 March 20X1, the asset is revalued to \$90,000. The tax rate is 30%.

**Required:**

**Explain the deferred tax implications of this situation.**

#### Share option schemes

Share option schemes with employees are a type of equity-settled share-based payment. In accordance with IFRS 2 *Share-based Payment*, a remuneration expense is recognised in profit or loss throughout the vesting period.

Tax relief is not normally granted until the share options are exercised. The amount of tax relief granted is based on the intrinsic value of the options (the difference between the market price of the shares and the exercise price of the option).

This delayed tax relief means that equity-settled share-based payment schemes give rise to a deferred tax asset.

The following pro-forma can be used to calculate the deferred tax asset arising on an equity-settled share-based payment scheme:

	\$	\$
Carrying amount of share-based payment	Nil	
Less:		
Tax base of the share-based payment*	(X)	
	—	
× Tax rate %	X	
	—	—
Deferred tax asset		X
		—

\* The tax base is the expected future tax relief (based on the intrinsic value of the options) that has accrued by the reporting date.

Where the amount of the estimated future tax deduction exceeds the accumulated remuneration expense, this indicates that the tax deduction relates partly to the remuneration expense and partly to equity. Therefore, the deferred tax must be recognised partly in profit or loss and partly in equity.



### Test your understanding 5 – Splash

An entity, Splash, established a share option scheme for its four directors. This scheme commenced on 1 July 20X8. Each director will be entitled to 25,000 share options on condition that they remain with Splash for four years, from the date the scheme was introduced.

Information regarding the share options is provided below:

Fair value of option at grant date	\$10
Exercise price of option	\$5

The fair value of the shares at 30 June 20X9 was \$17 per share.

A tax deduction is only given for the share options when they are exercised. The allowable deduction will be based on the intrinsic value of the options. Assume a tax rate of 30%.

#### Required:

**Calculate and explain the amounts to be included in the financial statements of Splash for the year ended 30 June 20X9, including explanation and calculation of any deferred tax implications.**

## Leases

### Leases and temporary differences

IFRS 16 *Leases* requires lessees to recognise a right-of-use asset and a lease liability for all leases, unless the lease is short-term or of minimal value.

Some jurisdictions grant tax relief on the leased asset, whereas other grant it on the lease liability. Temporary differences may be created depending on the tax laws in the jurisdiction the entity operates in.

At the date the lease is entered into, accounting profit and taxable profit are unaffected. However, if equal taxable and deductible temporary differences are created, deferred tax should be recognised.



### No temporary differences – an example

An entity enters into a lease agreement and the present value of the payments to be made is \$4 million. It records the following accounting entry:

Dr Right-of-use asset \$4m

Cr Lease liability \$4m

The right-of-use asset and lease liability both have a carrying amount of \$4 million.

If the tax jurisdiction grants tax relief in respect of the leased asset then:

- the right-of use asset has a tax base of \$4 million (the future allowable tax deduction)
- the lease liability has a tax base of \$4 million (carrying amount less any amount that will be deductible for tax purposes in future periods i.e. \$4m – nil).

No temporary differences arise on initial recognition of the transaction and so no deferred tax is accounted for. Deferred tax will be recognised subsequently if temporary differences arise.



### Temporary differences – an example

An entity enters into a lease agreement and the present value of the payments to be made is \$4 million. It records the following accounting entry:

Dr Right-of-use asset \$4m

Cr Lease liability \$4m

If the tax jurisdiction grants tax relief in respect of the lease liability then:

- the right-of use asset has a tax base of nil (the future allowable tax deduction)
- the lease liability has a tax base of nil (carrying amount less any amount that will be deductible for tax purposes in future periods - i.e. \$4m – \$4m).

Equal taxable and deductible temporary differences arise because the right-of-use asset and lease liability are both initially carried at \$4 million. As such, deferred tax should be recognised.



### Test your understanding 6 – Bittern

Bittern has a reporting date of 31 December 20X1. On the reporting date, it enters into a lease agreement to hire a machine. The present value of the lease payments to be made is \$10 million. In Bittern's tax jurisdiction, tax relief on leases is given in respect of the lease liability as payments are made. The tax rate is 30%.

**Required:**

**Discuss the deferred tax implications of the above in the year ended 31 December 20X1.**

### Additional lease payments

As noted, a lease liability is recognised in respect of lease payments to be made and a corresponding entry is made to a right-of-use asset:

- 1      Dr Right-of-use asset X  
         Cr Lease liabilities X

Any lease payments made in advance and any initial direct costs incurred by the lessee are added to the carrying amount of the right-of-use asset, but are not included in the carrying amount of the lease liability. The accounting entry for these payments is:

- 2      Dr Right-of-use asset X  
         Cr Cash X

Temporary differences arising from the first accounting entry are assessed for deferred tax recognition separately from the temporary differences arising from the second accounting entry.



### Test your understanding 7 – Justine

Justine has a reporting date of 31 December 20X1. On the reporting date, it enters into a lease agreement to hire a machine. On 31 December 20X1 Justine paid initial direct costs of \$0.2 million and made an advanced lease payment of \$1 million. The present value of the lease payments still to be made is \$8 million.

In Justine's tax jurisdiction, tax relief is given when lease payments and costs are incurred in cash. It has been ascertained that the tax relief granted is in relation to the lease liability. The tax rate is 20%.

**Required:**

**Discuss the deferred tax implications of the above in the year ended 31 December 20X1.**



## Unused tax losses

Where an entity has unused tax losses, IAS 12 allows a deferred tax asset to be recognised only to the extent that it is probable that future taxable profits will be available against which the unused tax losses can be utilised.

IAS 12 advises that the deferred tax asset should only be recognised after considering:

- whether an entity has sufficient taxable temporary differences against which the unused tax losses can be offset.
- whether it is probable the entity will make taxable profits before the tax losses expire.
- whether the cause of the tax losses can be identified and whether it is likely to recur (otherwise, the existence of unused tax losses is strong evidence that future taxable profits may not be available).
- whether tax planning opportunities are available.



### Test your understanding 8 – Red

As at 31 December 20X1, Red has tax adjusted losses of \$4 million which arose from a one-off restructuring exercise. Under tax law, these losses may be carried forward to relieve taxable profits in the future. Red has produced forecasts that predict total future taxable profits over the next three years of \$2.5 million. However, the accountant of Red is not able to reliably forecast profits beyond that date.

The tax rate for profits earned during the year ended 31 December 20X1 is 30%. However, the government passed legislation during the reporting period that lowered the tax rate to 28% from 1 January 20X2.

#### Required:

**Explain the deferred tax implications of the above.**

## 6 Business combinations and deferred tax

Accounting for a business combination, such as the consolidation of a subsidiary, can have several deferred tax implications.

### Fair value adjustments

The identifiable assets and liabilities of the acquired subsidiary are consolidated at fair value but the tax base derives from the values in the subsidiary's individual financial statements. A temporary difference is created, and so deferred tax must be recognised in the consolidated financial statements.

The deferred tax recognised is treated as part of the net assets of the subsidiary at the acquisition date and, as a result, affects the amount of goodwill recognised.

The goodwill itself does not give rise to deferred tax because IAS 12 specifically excludes it.



#### Test your understanding 9 – Tom

On 30 June 20X1 Tom acquired 100% of the shares of Jones for \$300,000. At this date, the carrying amount of the net assets of Jones was \$250,000. Included in this net asset figure is inventory which cost \$50,000 but which had a replacement cost of \$55,000. The applicable tax rate is 30%.

#### Required:

**Explain the deferred tax implications of the above in the consolidated financial statements of the Tom group.**

### Provisions for unrealised profit

When one company within a group sells inventory to another group company, unrealised profits remaining within the group at the reporting date must be eliminated. The following adjustment is required in the consolidated financial statements:

Dr Cost of sales (P/L)

Cr Inventory (SFP)

This adjustment reduces the carrying amount of inventory in the consolidated financial statements but the tax base of the inventory remains as its cost in the individual financial statements of the purchasing company.

This creates a **deductible temporary difference**, giving rise to a **deferred tax asset** in the consolidated financial statements.

Note: you may find it easier to think of this adjustment in terms of profits. The unrealised profit on the intra-group transaction is removed from the consolidated financial statements and therefore the tax charge on this profit must also be removed.



### Test your understanding 10 – Mug

Mug has owned 80% of the ordinary shares of Glass for many years. During the current year, Mug sold inventory to Glass for \$250,000 making a gross profit margin of 40%. One quarter of this inventory remains unsold by Glass at the reporting date.

The tax rate is 20%.

**Required:**

**Discuss the deferred tax implications of the above transaction.**

### Unremitted earnings

A temporary difference arises when the carrying amount of investments in subsidiaries, associates or joint ventures is different from the tax base.

- The carrying amount in consolidated financial statements is the investor's share of the net assets of the investee, plus purchased goodwill. The tax base is usually the cost of the investment. The difference is the unremitted earnings (i.e. undistributed profits) of the subsidiary, associate or joint venture.
- IAS 12 says that deferred tax should be recognised on this temporary difference except when:
  - the investor controls the timing of the reversal of the temporary difference and
  - it is probable that the profits will not be distributed in the foreseeable future.
- An investor can control the dividend policy of a subsidiary, but not always that of other types of investment. This means that deferred tax does not arise on investments in subsidiaries, but may arise on investments in associates and joint ventures.

Financial assets may give rise to deferred tax if they are remeasured to fair value.

## 7 Disclosure

An entity must disclose:

- the major components of its tax expense
- tax recognised directly in equity
- tax relating to items recognised directly in equity
- tax relating to each component of other comprehensive income
- an explanation of the relationship between tax expense and accounting profit.



### Test your understanding 11 – HCRM

In the year ended 31 December 20X1, HCRM recorded a profit before tax of \$300 million. Its tax rate is 20%.

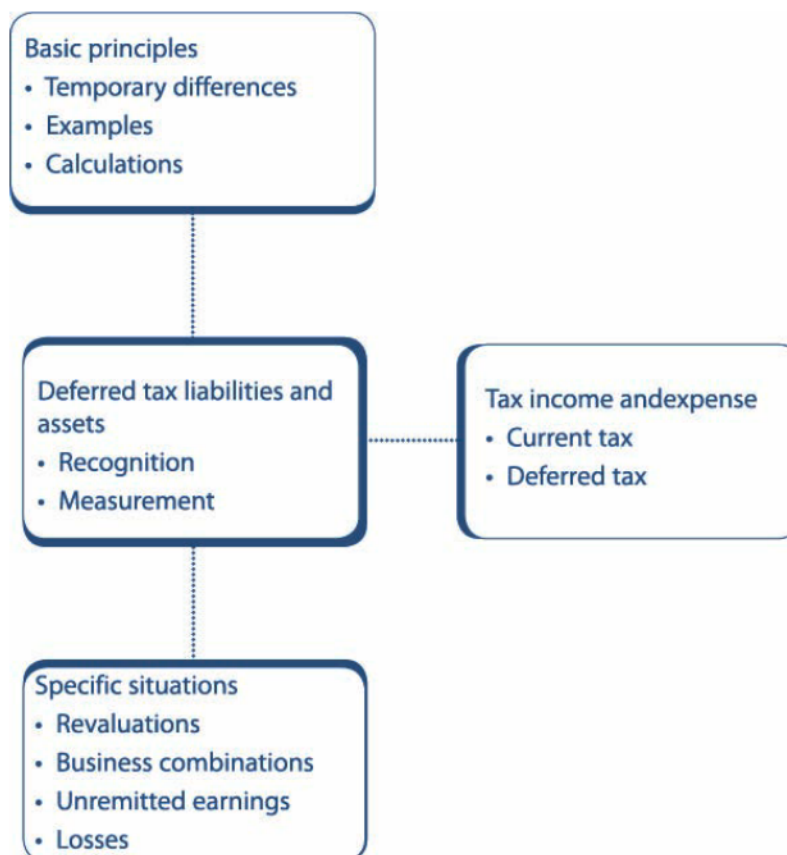
In accordance with IAS 12 *Income Taxes*, it has disclosed the following information in its published financial statements:

	\$m
PBT	300.0
PBT multiplied by 20% tax rate	60.0
Adjustments to current tax in respect of prior years	8.2
Depreciation on assets not qualifying for tax relief	1.5
Sundry disallowables	0.7
	<hr/>
Total tax charge	70.4
	<hr/>
Effective tax rate (%)	23.5

#### Required:

**Discuss why this disclosure provides useful information to HCRM's investors.**

## 8 Chapter summary





## Test your understanding answers



### Test your understanding 1 – Dive (temporary differences)

	Carrying amount	Tax base	Temp. difference
	\$	\$	\$
Non-current asset	82,000	70,000	12,000
Interest receivable	1,000	Nil	1,000
Receivables	10,000	10,000	Nil
Inventory	4,500	5,000	(500)
Accrual (cash basis for tax)	(1,000)	Nil	(1,000)
Accrual (already had tax relief)	(5,000)	(5,000)	Nil



### Test your understanding 2 – Dive (deferred tax calculation)

The net temporary difference as at the reporting date is as follows:

	\$
Non-current assets	12,000
Interest receivables	1,000
Receivables	–
Inventory	(500)
Accrual (cash basis for tax)	(1,000)
Accrual (already had tax relief)	–
	<hr/>
	11,500
	<hr/>

There will be a deferred tax liability because the carrying amount of the net assets and liabilities exceeds their net tax base. The deferred tax liability is calculated by applying the relevant tax rate to the temporary difference.

The deferred tax liability is therefore \$3,450 ( $\$11,500 \times 30\%$ ).

Assuming that there is no opening deferred tax liability, the following accounting entry is required:

Dr Tax expense (P/L)	\$3,450
Cr Deferred tax liability (SFP)	\$3,450



### Test your understanding 3 – Brick

Deferred tax liabilities and assets should be measured using the tax rates expected to apply when the asset is realised. This tax rate must have been enacted or substantively enacted by the end of the reporting period.

The government enacted the 20% tax rate after the period end. Therefore, it should not be used when calculating the deferred tax liability for the year ended 30 April 20X4. The current 22% rate should be used instead.

Per IAS 10, changes in tax rates after the end of the reporting period are a non-adjusting event. However, if the change in the tax rate is deemed to be material then Brick should disclose this rate change and an estimate of the financial impact.



### Test your understanding 4 – Dodge

The carrying amount of the asset is \$90,000 and the tax base is \$50,000 (\$100,000 – \$50,000). The carrying amount exceeds the tax base by \$40,000 (\$90,000 – \$50,000).

This temporary difference will give rise to a deferred tax liability of \$12,000 (\$40,000 × 30%).

Prior to the revaluation, the carrying amount of the asset was \$60,000. The asset was then revalued to \$90,000. Therefore, \$30,000 (\$90,000 – \$60,000) of the temporary difference relates to the revaluation.

Revaluation gains are recorded in other comprehensive income and so the deferred tax charge relating to this gain should also be recorded in other comprehensive income. This means that the tax charged to other comprehensive income is \$9,000 (\$30,000 × 30%).

The following accounting entry is required:

Dr Other comprehensive income	\$9,000
Dr Profit or loss (bal. fig.)	\$3,000
Cr Deferred tax liability	\$12,000

The balance on the revaluation reserve within other components of equity will be \$21,000 (\$30,000 revaluation gain – \$9,000 deferred tax).



### Test your understanding 5 – Splash

The expense recognised for an equity-settled share-based payment scheme is calculated based on the fair value of the options at the grant date. This expense is spread over the vesting period. At each reporting date, the entity should reassess the number of options expected to vest.

The expense for the scheme in the year ended 30 June 20X9 is \$250,000 ( $4 \times 25,000 \times \$10 \times 1/4$ ).

For tax purposes, tax relief is allowed based on the intrinsic value of the options at the date they are exercised.

At the reporting date, the shares have a market value of \$17 but the options allow the holders to purchase these shares for \$5. The options therefore have an intrinsic value of \$12 ( $\$17 - \$5$ ).

The deferred tax asset is calculated as follows:

	\$	\$
Carrying amount of share-based payment	Nil	
Tax base of the share-based payment ( $4 \times 25,000 \times (\$17 - \$5) \times 1/4$ )	(300,000)	
	<hr/>	
× Tax rate 30%	(300,000)	
		<hr/>
Deferred tax asset		90,000
		<hr/>

Where the amount of the estimated future tax deduction exceeds the accumulated remuneration expense, this indicates that the tax deduction relates partly to the remuneration expense and partly to equity.

In this case, the estimated future tax deduction is \$300,000 whereas the accumulated remuneration expense is \$250,000. Therefore, \$50,000 of the temporary difference is deemed to relate to an equity item, and the deferred tax relating to this should be credited to equity.

The following entry is required:

Dr Deferred tax asset	\$90,000
Cr Equity ( $\$50,000 \times 30\%$ )	\$15,000
Cr Profit or loss ( $\$250,000 \times 30\%$ )	\$75,000

If the deferred tax asset is to be recognised, it must be regarded as recoverable.



### Test your understanding 6 – Bittern

In accordance with IFRS 16 *Leases*, a right-of-use asset and a lease liability are recognised for \$10 million.

The tax relief granted relates to the lease liability rather than the right-of-use asset. The tax base of the right-of-use asset is nil (no future tax relief is granted). Its carrying amount is \$10 million and so a taxable temporary difference of \$10 million arises.

The tax base of the lease liability is nil (\$10m carrying amount less \$10m future tax relief). The carrying amount of the lease liability is \$10 million, so a deductible temporary difference of \$10 million arises.

This transaction is not a business combination and it affects neither accounting profit nor taxable profit. However, equal amounts of deductible and taxable temporary differences are created.

A deferred tax asset would be recognised for \$3 million ( $\$10\text{m} \times 30\%$ ), assuming that sufficient future profits are expected against which the difference can be utilised. A deferred tax liability would also be recognised for \$3 million.

The entry required is:

Dr Deferred tax assets \$3m

Cr Deferred tax liabilities \$3m



### Test your understanding 7 – Justine

#### Lease liability and associated asset cost

The present value of the payments to be made is \$8 million and so a lease liability is recognised for this amount with a corresponding entry made to a right-of-use asset.

The tax relief granted relates to the lease liability rather than the right-of-use asset. This means that the tax base of the lease liability is nil (\$8m carrying amount less \$8m future tax relief) but the carrying amount of the lease liability is \$8 million. This creates a deductible temporary difference of \$8 million.

The tax base of the right-of-use asset is nil (no future tax relief is granted) but the carrying amount of the right-of-use asset associated with the lease liability is \$8 million. A taxable temporary difference of \$8 million arises (Note: the initial costs and payments are dealt with separately below).

This transaction is not a business combination and it affects neither accounting profit nor taxable profit. However, it has created equal amounts of deductible and taxable temporary differences.

A deferred tax asset would be recognised for \$1.6 million ( $\$8\text{m} \times 20\%$ ), assuming that sufficient future profits are expected against which the difference can be utilised. A deferred tax liability would also be recognised for \$1.6 million.

The entry required is:

Dr Deferred tax assets \$1.6m

Cr Deferred tax liabilities \$1.6m

### Initial costs and payments

The initial direct costs and advanced payment are included in the right-of-use asset. Together, these two payments have a carrying amount of \$1.2 million. The tax base is nil. This is a taxable temporary difference of \$1.2 million.

The payments do not affect accounting profit, but they do affect taxable profit, so a deferred tax liability is recognised for \$0.24 million ( $\$1.2\text{m} \times 20\%$ ). A corresponding tax expense is recognised in the statement of profit or loss.

Dr Tax expense (P/L) \$0.24m

Cr Deferred tax liabilities \$0.24m



### Test your understanding 8 – Red

A deferred tax asset can be recognised if it is deemed probable that future taxable profits will be available against which the unused losses can be utilised.

The tax losses have arisen from an exceptional event, suggesting that the entity will return to profitability. Forecasts produced by the accountant confirm this.

Red is only able to reliably forecast future profits of \$2.5m. This limits the deferred tax asset that can be recognised.

Deferred tax should be calculated using the tax rate that is expected to be in force when the temporary difference reverses based on the rates enacted by the reporting date. This means that the 28% rate should be used.

The deferred tax asset that can be recognised is therefore \$700,000 ( $\$2.5\text{m} \times 28\%$ ). There will be a corresponding credit to the tax expense in the statement of profit or loss.





### Test your understanding 9 – Tom

According to IFRS 3 *Business Combinations*, the net assets of the subsidiary at the acquisition date must be consolidated at fair value. The carrying amount of the inventory in the group financial statements will be \$55,000. The tax base of the inventory is based on its carrying amount of \$50,000 in the individual financial statements. Therefore, there is a temporary difference of \$5,000 that arises on consolidation.

A deferred tax liability must be recognised in the consolidated financial statements for \$1,500 ( $\$5,000 \times 30\%$ ). This is treated as a reduction in the subsidiary's net assets at the acquisition date, which will increase the goodwill arising on acquisition.

	\$	\$
Consideration		300,000
Net assets:		
Carrying amount	250,000	
Fair value uplift	5,000	
Deferred tax liability	(1,500)	
	<hr/>	(253,500)
Goodwill at acquisition		<hr/> 46,500 <hr/>



### Test your understanding 10 – Mug

There has been an intra-group sale and some of the inventory remains within the group at the reporting date. The profits held within this unsold inventory must therefore be removed from the consolidated statements.

The profit on the sale was \$100,000 ( $\$250,000 \times 40\%$ ). Of this, \$25,000 ( $\$100,000 \times 25\%$ ) remains within the inventory of the group. The adjustment required to eliminate the unrealised profits is:

Dr Cost of sales	\$25,000
Cr Inventory	\$25,000

The carrying amount of inventory in the consolidated financial statements is now \$25,000 lower than its tax base, creating a deductible temporary difference of \$25,000. This gives rise to a deferred tax asset of \$5,000 ( $\$25,000 \times 20\%$ ) in the consolidated statement of financial position as well as a corresponding reduction to the tax expense in the consolidated statement of profit or loss. The adjustment required to account for the deferred tax is:

Dr Deferred tax asset	\$5,000
Cr Tax expense	\$5,000

**Test your understanding 11 – HCRM**

Users of the financial statements need information to help them assess an entity's future profits and future cash flows. The tax rate reconciliation is important for understanding the tax charge reported in the financial statements and why the effective tax rate differs from the statutory rate.

The main reason for the difference between the statutory tax rate and the effective tax rate is due to current tax adjustments. HCRM under-accrued in prior periods for current tax, resulting in additional expense in the current period. Investors need to assess whether the effective tax rate is likely to be static or volatile and so must analyse comparative information to understand whether HCRM has a history of under-accruing (or over-accruing) for current tax. This will inform profit and cash flow forecasts.

One-off and unusual items can have a significant effect on the effective tax rate. Depreciation on assets that do not qualify for tax relief is likely to be a recurring item year-on-year. Other reconciling items should be explained so that investors can assess if they are likely to recur. To provide transparency, there should be minimal use of the 'sundry disallowables' category. In HCRM's reconciliation, this sundry category is relatively insignificant, although more information might be useful depending on the nature of these items.

Investors should also refer to the statement of cash flows, which will specify the tax paid in the current period.

## Segment reporting

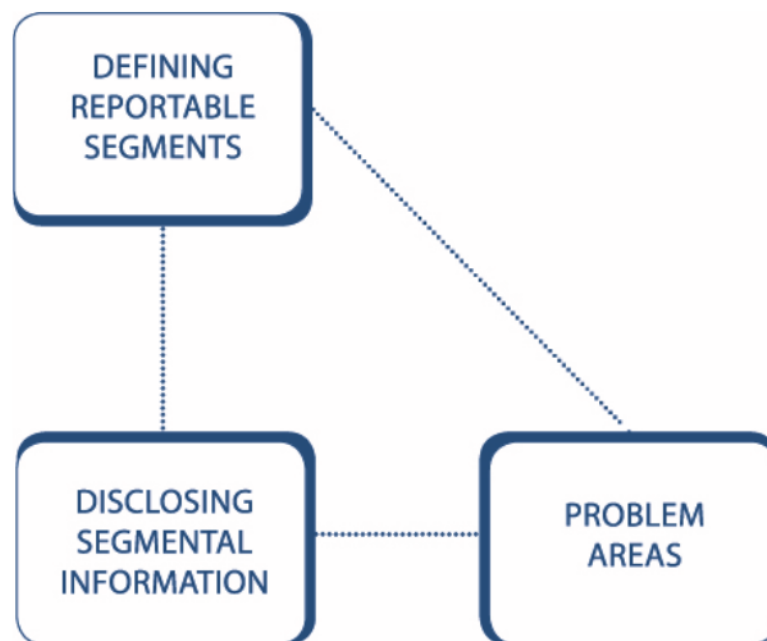
### Chapter learning objectives

Upon completion of this chapter you will be able to:

- Determine the nature and extent of reportable segments
- Discuss the nature of segment information to be disclosed and how segmental information enhances the quality and sustainability of performance.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



## 1 Defining reportable segments

### Introduction



#### Progression

You will not have studied this topic in earlier ACCA exams.

Segmental reports are designed to reveal significant information that might otherwise be hidden by the process of presenting a single statement of profit or loss and other comprehensive income and statement of financial position for an entity.

IFRS 8 *Operating Segments* requires certain entities to disclose information about each of its operating segments that will enable users of the financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

IFRS 8 applies to entities which trade debt or equity instruments in a public market.



An **operating segment** is defined as a component of an entity:

- **'that engages in business activities from which it may earn revenues and incur expenses**
- **whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance**
- **for which discrete financial information is available'** (IFRS 8, para 5).



### How to define reportable segments

Under IFRS 8, an operating segment is a component whose results are regularly reviewed by the entity's chief operating decision maker. This means that the segments reported in the financial statements should be the same as those reviewed in internal management reports.

Management may use more than one set of segment information. For example, they might analyse information by classes of business (different products or services) and by geographical areas. If this is the case then management must identify a **single** set of components on which to base the segmental disclosures. The basis of reporting information should be the one that best enables users to understand the business and the environment in which it operates.

Not every part of an entity is necessarily an operating segment or part of an operating segment:

- Corporate headquarters and other similar departments do not earn revenue and are therefore not operating segments.
- An entity's pension plan is not an operating segment.

### Aggregation

IFRS 8 says that two or more operating segments can be aggregated and reported as a single operating segment provided that they have similar economic characteristics, and are similar in the following respects:

- products and services
- production processes
- classes of customer
- distribution methods.



#### Test your understanding 1 – E-Games

E-Games is a UK based company that sells computer games and hardware. Sales are made through the E-Games website as well as through high street stores. The products sold online and in the stores are the same. E-Games sells new releases for \$40 in its stores, but for \$30 online.

Internal reports used by the chief operating decision maker show the results of the online business separately from the stores. However, they will be aggregated together for disclosure in the financial statements.

#### Required:

**Should the online business and the high street stores be aggregated into a single segment in the operating segments disclosure?**



### Quantitative thresholds

An entity must separately report information about an operating segment that meets any of the following quantitative thresholds:

- **'its reported revenue, including both sales to external customers and inter-segment sales, is ten per cent or more of the combined revenue of all operating segments**
- **its reported profit or loss is ten per cent or more of the greater, in absolute amount, of:**
  - **the combined reported profit of all operating segments that did not report a loss and**
  - **the combined reported loss of all operating segments that reported a loss.**
- **its assets are ten per cent or more of the combined assets of all operating segments'** (IFRS 8, para 13).

At least 75% of the entity's external revenue must be included in reportable segments. Other segments should be identified as reportable segments until 75% of external revenue is reported.

Information about other business activities and operating segments that are not reportable are combined into an 'all other segments' category.



### Test your understanding 2 – Identifying reportable segments

The management of a company have identified operating segments based on geographical location. Information for these segments is provided below:

Segment	Total revenue	External revenue	Internal revenue	Profit/ (loss)	Assets
	\$000	\$000	\$000	\$000	\$000
Europe	260	140	120	98	3,400
Middle East	78	33	45	(26)	345
Asia	150	150	–	47	995
North America	330	195	135	121	3,800
Central America	85	40	45	(15)	580
South America	97	54	43	12	880
	<u>1,000</u>	<u>612</u>	<u>388</u>	<u>237</u>	<u>10,000</u>

**Required:**

**According to IFRS 8, which segments must be reported?**



## 2 Disclosing reportable segments

### General information

IFRS 8 requires disclosure of the following:

- Factors used to identify reportable segments
- The types of products and services sold by each reportable segment.

### Information about profit or loss and other segment items

For each reportable segment an entity should report:

- a measure of profit or loss
- a measure of total assets.

Other information should be disclosed if regularly provided to the chief operating decision maker.

IFRS 8 requires segmental reports to be based on the information reported to and used by management, even where this is prepared on a different basis from the rest of the financial statements. Therefore, an entity must provide explanations of the measurement of segment profit or loss, segment assets and segment liabilities.



### Example of a segmental report

	Segment A	Segment B	Segment C	All other	Totals
	\$000	\$000	\$000	\$000	\$000
Revenues from external customers	5,000	9,500	12,000	800	27,300
Revenues from inter-segment transactions	–	3,000	1,500	–	4,500
Interest income	800	1,000	1,500	–	3,300
Interest expense	600	700	1,100	–	2,400
Depreciation and amortisation	100	50	1,500	–	1,650
Exceptional costs	200	–	–	–	200
Segment profit	70	900	2,300	100	3,370
Impairment of assets	200	–	–	–	200
Segment assets	5,000	3,000	12,000	400	20,400
Additions to non-current assets	700	500	800	–	2,000
Segment liabilities	3,000	1,800	8,000	–	12,800

### Notes

- 1 The 'all other' column shows amounts relating to segments that fall below the quantitative thresholds.
- 2 Impairment of assets is disclosed as a material non-cash item.

### 3 Assessing segmental reporting



#### Investor perspective

Segmental reports provide investors with an array of useful information.

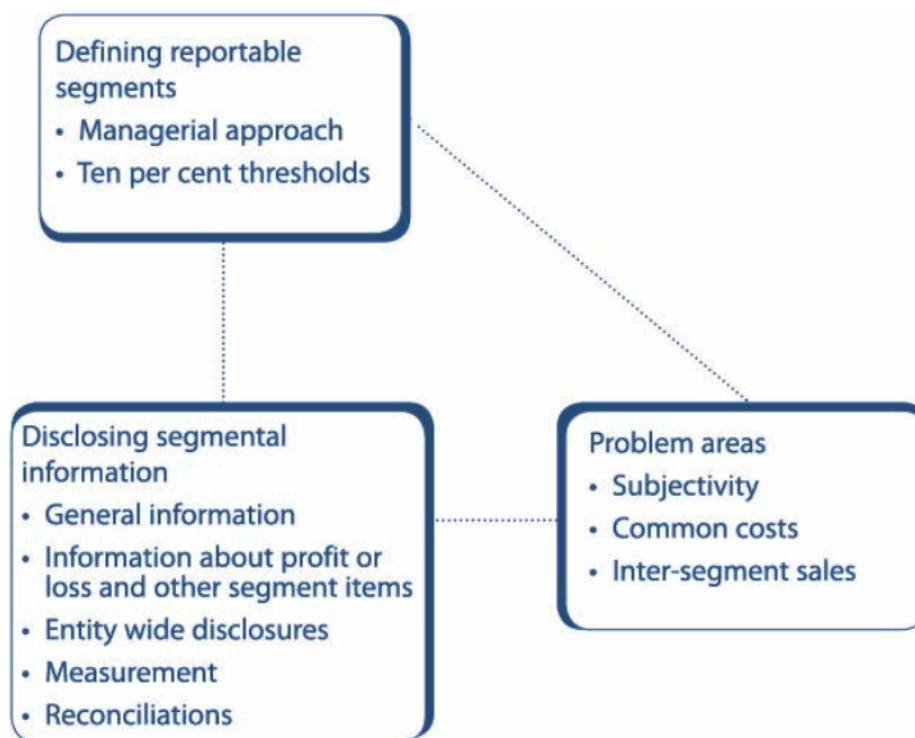
- Entities produce segmental reports from a 'management perspective'. Investors are interested in how management views the business.
- Different parts of the business will have different growth opportunities. Segmental information may help investors to better predict future performance and future cash flows.
- Geographical disclosures are useful for investors in multi-national businesses because each country/location may face different risks (including political risks) and growth rates.

Moreover, segmental reporting requirements are relatively cheap for entities to comply with because the information is already produced for internal use. Therefore, the benefits of this information far exceed the cost of production.

Segmental reports have some limitations:

- Trading between segments may distort the results of each operating segment, particularly if the transactions do not occur at fair value.
- IFRS 8 states that segments should reflect the way in which the entity is managed. This means that segments information is not useful for comparing the performance of different entities.
- The segmentation process is based on management's perspective, and some users lack trust in management's intentions. For example, management may attempt to conceal loss-making areas of the business within a larger, profitable reportable segment.
- Many entities over-aggregate segments, which reduces the level of detail reported to stakeholders.
- Common costs may be allocated to different segments on whatever basis the directors believe is reasonable. This can lead to arbitrary cost allocation.

## 4 Chapter summary



## Test your understanding answers



### Test your understanding 1 – E-Games

IFRS 8 says that two or more operating segments may be aggregated into a single segment if they have similar economic characteristics and the segments are similar in the following respects:

- The nature of products or services.
- The types of customer.
- Distribution methods.

The standard says that segments with similar economic characteristics would have similar long-term gross margins.

The E-Games stores and online business sell the same types of product, and there are likely to be no major differences in the types of customer (individual consumers). Therefore, in these respects, the segments are similar.

However, customers will collect their goods from the stores, but E-Games will deliver the products sold online. This means that distribution methods are different.

Moreover, there are different sales prices between the stores and the online business, giving rise to significant differences in gross margin. This suggests dissimilarity in terms of economic characteristics.

This means that it might be more appropriate to disclose these two segments separately.

#### **Note:**

There is no 'right' or 'wrong' answer here. There are numerous retailers who do not disclose their online operations as a separate segment. However, the Board notes in its post-implementation review of IFRS 8 that many companies are over-aggregating segments. For exam purposes, it is important to state the relevant recognition criteria and then to apply these to the information given in the question.





### Test your understanding 2 – Identifying reportable segments

#### The 10% tests

Segment	10% total revenue (W1)	10% results test (W2)	10% assets (W3)	Report?
Europe	Y	Y	Y	Y
Middle East	N	N	N	N
Asia	Y	Y	N	Y
North America	Y	Y	Y	Y
Central America	N	N	N	N
South America	N	N	N	N

Europe, Asia and North America are reportable. However, we must check whether they comprise at least 75% of the company's external revenue.

#### The 75% test

	External revenue \$000
Europe	140
Asia	150
North America	195
	<hr/>
Total	485
	<hr/>

The external revenue generated by reportable segments is 79% (\$485,000/ \$612,000) of total external revenue. The 75% test is met and no other segments need to be reported.

#### Conclusion

The reportable segments are Europe, Asia and North America.

#### (W1) 10% of total sales

$$10\% \times \$1\text{m} = \$100,000.$$

All segments whose total sales exceed \$100,000 are reportable.

#### (W2) 10% of results

10% of profit making segments:

$$10\% \times (\$98,000 + \$47,000 + \$121,000 + \$12,000) = \$27,800$$

10% of loss making segments:

$$10\% \times (\$26,000 + \$15,000) = \$4,100$$

Therefore, all segments which make a profit or a loss of greater than \$27,800 are reportable.

#### (W3) 10% of total assets

$$10\% \times \$10\text{m} = \$1\text{m}.$$

All segments whose assets exceed \$1m are reportable.



## Related parties

### Chapter learning objectives

Upon completion of this chapter you will be able to:

- Identify related parties and assess the implications of related party relationships in the preparation of corporate reports.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



### 1 The need for disclosure of related parties

A related party transaction is defined by IAS 24 *Related Party Disclosures* as **'the transfer of resources, services or obligations between related parties, regardless of whether a price is charged'** (IAS 24, para 6).

Transactions between related parties are a normal feature of business. However, users of the financial statements need to know about these transactions because they can distort the financial performance and position of an entity.



#### The need for related party disclosures

Company A owns 75% of the equity shares of B. Company A sells goods to Company B at prices significantly above market rate. As a result, the profit of Company A is higher than if it had sold all of its goods to a third party.

Company A's financial statements are not comparable with those of similar companies. Its performance has been distorted as a result of trading with an entity that it controls.

Companies A and B are related parties. Users of the financial statements, such as investors and banks, need to be made aware of the transactions that have occurred between these two companies to enable them to make a proper assessment of the financial statements.

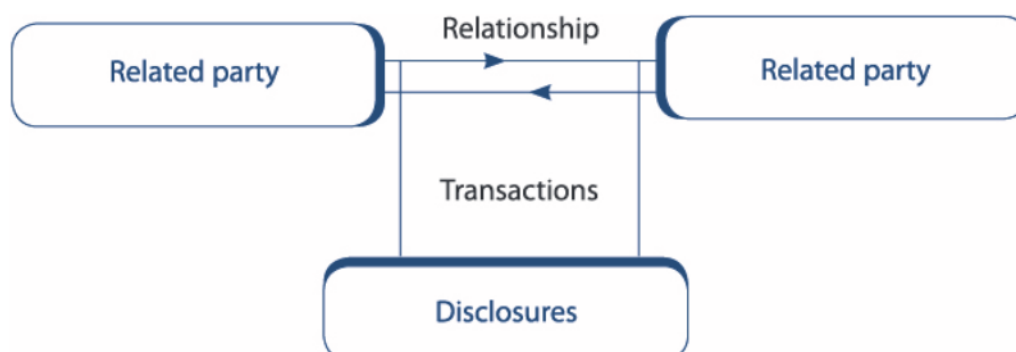


### Progression

Related party transactions are an area of audit risk that you may encounter in Advanced Audit and Assurance.



## 2 Definition of a related party



A related party is defined as **'a person or entity that is related to the entity that is preparing its financial statements'** (IAS 24, para 9).

IAS 24 (para 9) gives the following rules which should be used to determine the existence of related party relationships:

- (a) **'A person or a close member of that person's family is related to a reporting entity if that person:**
  - (i) **has control or joint control of the reporting entity**
  - (ii) **has significant influence over the reporting entity**
  - (iii) **is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.**
- (b) **An entity is related to a reporting entity if any of the following conditions apply:**
  - (i) **The entity and the reporting entity are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others)**
  - (ii) **One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member)**
  - (iii) **Both entities are joint ventures of the same third party**
  - (iv) **One entity is a joint venture of a third entity and the other entity is an associate of the third entity**
  - (v) **The entity is a post-employment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity**



- (vi) **The entity is controlled or jointly controlled by a person identified in (a)**
- (vii) **A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity)**
- (viii) **The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity.'**

Group accounting is covered in a later chapter. You may therefore find the following definitions useful:

- A **subsidiary** is an entity over which an investor has control.
- A **joint venture** is an entity over which an investor has joint control.
- An **associate** is an entity over which an investor has significant influence.

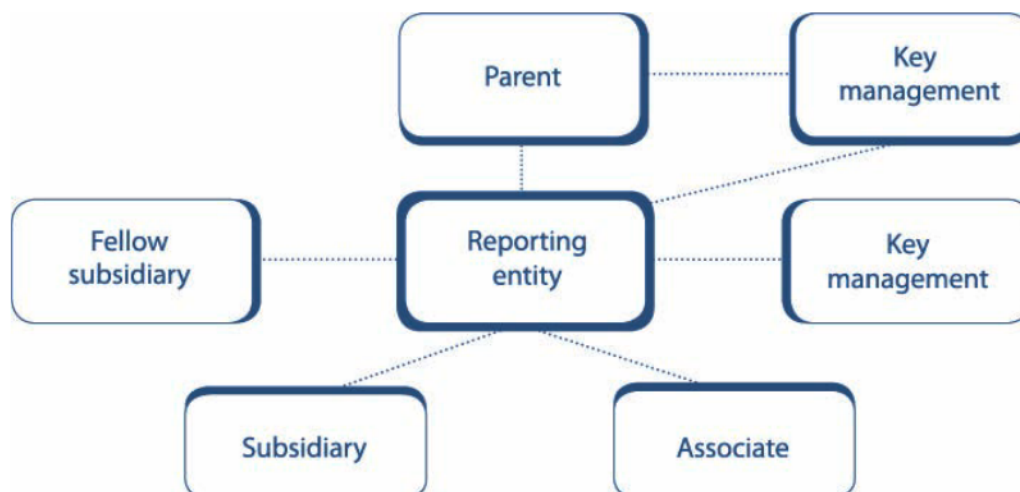
Note that, in the definition of a related party, '**an associate includes subsidiaries of the associate and a joint venture includes subsidiaries of the joint venture**' (IAS 24, para 12).

IAS 24 notes that the following should not be considered related parties:

- two entities just because they have a director or other member of key management personnel in common
- two joint venturers just because they share joint control of a joint venture
- a customer or supplier with whom an entity transacts a significant volume of business.

Substance over form should be applied when deciding if two parties are related.

### Related parties summary





### Further detail on definitions

'Close members of family include:

- that person's children and spouse or domestic partner
- children of that person's spouse or domestic partner
- dependants of that person or that person's spouse or domestic partner' (IAS 24, para 9).

**Control** is defined in IFRS 10. An investor **controls an investee** when:

- the investor has power over the investee, and
- the investor is exposed, or has rights, to variable returns from its involvement with the investee, and
- the investor has the ability to affect those returns through its power over the investee.

In simple terms, control is normally assumed when one entity owns more than half of the equity shares of another entity.

**Significant influence** is defined in IAS 28 Investments in Associates and Joint Ventures as the '**power to participate in, but not control, the financial and operating policy decisions of an entity**' (IAS 28, para 3). Significant influence is normally assumed when an entity owns between 20% and 50% of the equity shares of another entity.

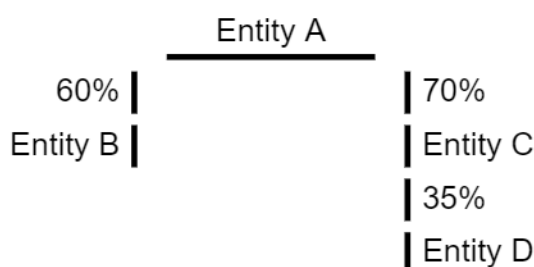
**Joint control** is defined in IFRS 11 Joint Arrangements as '**the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control**' (IFRS 11, para 7).

**Key management personnel** are defined as '**those with authority and responsibility for planning, directing and controlling the activities of the entity, including any director (whether executive or otherwise) of that entity**' (IAS 24, para 9).



### Test your understanding 1 – Group structures

Consider the following structure:



**Required:**

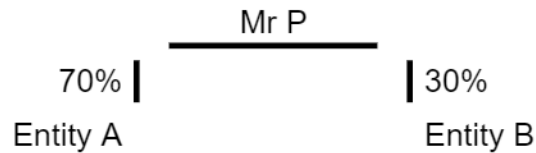
**Identify the related party relationships within the above structure.**



### Test your understanding 2 – Individual shareholdings

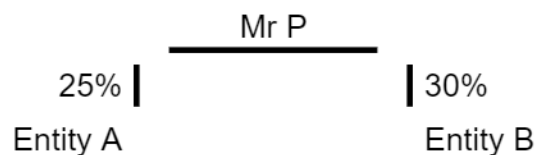
Consider each of the following situations:

(a)



Mr P controls entity A and is able to exert significant influence over entity B.

(b)



Mr P is able to exert significant influence over entity A and entity B.

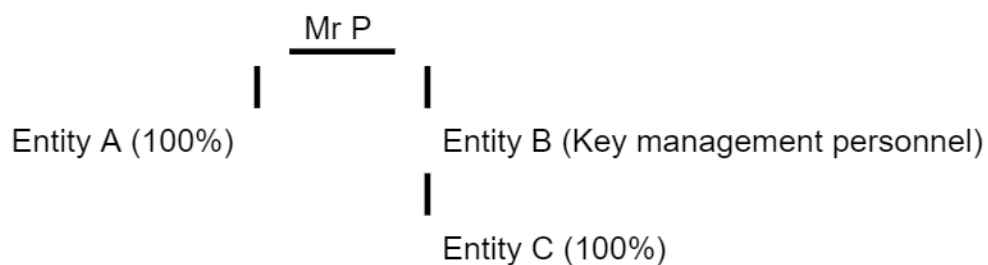
**Required:**

**For each situation explain whether or not entity A and entity B are related parties.**



### Test your understanding 3 – Key management personnel

Consider the following situation:



Mr P owns all of the issued share capital of entity A. He also is a member of the key management personnel of entity B which, in turn, owns all of the issued share capital of entity C.

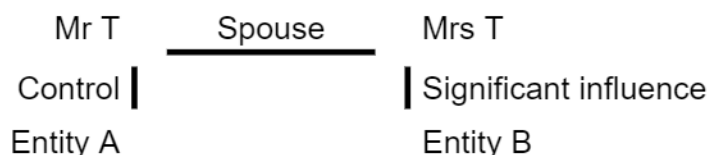
**Required:**

**Discuss the related party relationships arising from the above structure.**



### Test your understanding 4 – Family members

Consider the following situation:



Mr T controls entity A. His spouse, Mrs T, exercises significant influence over entity B.

**Required:**

**Discuss the related party relationships arising from the above.**

## 3 Disclosure of related parties

### Parent and subsidiary relationships

IAS 24 requires that relationships between parents and subsidiaries should always be disclosed. The name of the parent and, if different, the ultimate controlling party should be given.

### Key management personnel

Total compensation granted to key management personnel should be disclosed and broken down into the following categories:

- short-term benefits
- pension benefits
- termination benefits
- share-based payment schemes.

### Disclosure of transactions and balances

If there have been transactions between related parties, and/or if there are balances outstanding between the parties, the following should be disclosed:

- the nature of the related party relationship
- a description of the transactions
- the amounts of the transactions
- the amounts and details of any outstanding balances
- allowances for receivables in respect of the outstanding balances
- the irrecoverable debt expense in respect of outstanding balances.

IAS 24 specifies that an entity may only disclose that related party transactions were made on terms equivalent to those that prevail in arm's length transactions if such terms can be substantiated.

### Government-related entities

A reporting entity is exempt from the above disclosures in respect of transactions and balances that they have with a government that has control, joint control or significant influence over the reporting entity.

If this exemption is applied, IAS 24 requires that the following disclosures are made instead:

- details of the government and a description of its relationship with the reporting entity
- details of individually significant transactions
- an indication of the extent of other transactions that are significant in aggregate.



#### Investor perspective – related party sales

Patrol reported revenue of \$500 million in the year ended 20X1 and \$450 million in the year ended 20X0. This is an increase of 11%. The average revenue increase in the market in which Patrol operates was 5%.

An extract from Patrol's related party disclosure note is provided below:

#### Sales to related parties

	20X1	20X0
	\$m	\$m
Joint ventures	40	10
Associates	15	5

Joint ventures are entities over which Patrol has joint control. Associates are entities over which Patrol has significant influence. These relationships may have enabled Patrol to push through extra sales in the current year to improve perception of its performance.

If the related party sales were stripped out then revenue in 20X1 would be \$445 million and revenue in 20X0 would be \$435 million. This is a 2.3% increase year-on-year, which is below the average market increase.

The information is relevant because it might deter further investment in Patrol, whether from new or potential investors.





### Investor perspective – key management personnel compensation

Below is an extract from the related parties disclosure note of Rich, a public limited company, for the year ended 31 December 20X1:

#### Remuneration of key management personnel

	20X1	20X0
	\$m	\$m
Short-term employee benefits	2.3	1.7
Post-employment benefits	0.2	0.2
Share-based payments	0.5	0.1
	<hr/>	<hr/>
	3.0	2.0
	<hr/>	<hr/>

*Short-term employee benefits comprise salary and benefits earned during the year and bonuses awarded for the year.*

As can be seen, remuneration of key management personnel has increased year-on-year by \$1 million. This is a 50% increase. Some of this is related to salary and bonuses, whereas the rest is related to share-based payments.

Users of the financial statements would need to assess whether the financial performance of Rich justifies such a large increase in remuneration. If not, the information presented in the disclosure note may suggest that the directors are exercising poor stewardship over the entity's assets and that corporate governance arrangements are weak. Moreover, higher management remuneration may mean less cash available to pay dividends to ordinary shareholders. In response, some investors might sell their shares in Rich.



### Test your understanding 5 – Picture and Frame

Joanne Smith has owned 60% of the equity shares of Picture and 70% of the equity shares of Frame for many years. On 1 January 20X4, Picture entered into a lease agreement with Frame. Under the terms of the lease, Picture would lease one of its unused warehouses, with a remaining useful life of 20 years, to Frame for five years. Consideration payable by Frame would be \$10,000 a year in arrears. Market rentals for similar sized warehouses tend to be around \$100,000 per year.

#### Required:

**Discuss the correct treatment of the above transaction in Picture's financial statements for the year ended 30 June 20X4.**



### Test your understanding 6 – Beth and Banger

A single investor has a controlling shareholding in Beth and Banger. Banger and Beth are not within the same group.

Towards the end of the reporting period Beth made a large number of sales to Banger in excess of normal selling prices. The finance director of Beth has not disclosed these transactions in the financial statements.

**Required:**

**Discuss the accounting and ethical issues arising from the above.**

#### 4 Chapter summary

The need for disclosure of related parties

- Users need to be aware of related party relationships because transactions may not have happened at normal market rates.



Disclosure of related parties

- Parent/subsidiary relationships
- Disclosure of transactions and balances
- Key management compensation

## Test your understanding answers



### Test your understanding 1 – Group structures

#### Entity A:

Entities that are within the same group are related to one another. Entities B and C are therefore related parties of A.

D is an associate of C. C is a member of A's group. This means that D is a related party of A.

#### Entity B:

Entities that are within the same group are related to one another. Entities A and C are therefore related parties of B.

D is an associate of C. C is a member of the same group as B. This means that D is a related party of B.

#### Entity C:

Entities that are within the same group are related to one another. Entities A and B are therefore related parties of C.

Entities are related if one is an associate of another. C and D are therefore related parties.

#### Entity D:

Entities are related if one is an associate of another. D and C are therefore related parties.

Entities are related if one is an associate of a member of a group of which the other entity is also a member. D is an associate of C. Companies A and B are in the same group as C. This means that D is also a related party of A and B.



### Test your understanding 2 – Individual shareholdings

#### Situation A:

Mr P is a related party of both entity A and entity B as he is able to exercise either control or significant influence over each entity.

Mr P controls entity A and has significant influence over entity B. Therefore, A and B are related parties.

#### Situation B:

Mr P is a related party of both entity A and entity B as he is able to exercise significant influence over each entity.

Mr P does not control either entity A or entity B. Therefore, A and B are not related parties.



### Test your understanding 3 – Key management personnel

Mr P has control over entity A, meaning that Mr P is a related party of A.

Mr P is a member of key management personnel of B, so is a related party of B.

A and B are related parties, because Mr P controls A and is a member of key management personnel of B.

Entity B controls entity C so B and C are related parties.

Mr P is a member of key management personnel of the parent of C, so Mr P and C are related parties.

This means that entities A and C are also related parties (Mr P controls A and is a member of key management personnel of the parent company of C).



### Test your understanding 4 – Family members

Mr T and Mrs T are close family.

Mr T controls entity A. Mr T and Mrs T are related parties of entity A.

Mrs T has significant influence over entity B. Mrs T and Mr T are related parties of entity B.

Mr and Mrs T control entity A and have significant influence over entity B. A and B are related parties.



### Test your understanding 5 – Picture and Frame

According to IFRS 16 *Leases*, a finance lease is a lease where substantially all of the risks and rewards of ownership transfer to the lessee. The lease between Picture and Frame is only for a fraction of the asset's remaining useful life and the lease payments are insignificant. The lease is therefore an operating lease. Picture should recognise lease income on a straight line basis over the lease term. Therefore, \$5,000 ( $\$10,000 \times 6/12$ ) should be recognised in the current year's statement of profit or loss, as well as a corresponding entry to accrued income on the statement of financial position.

Picture and Frame are under joint control of Joanne Smith, so this means that they are related parties. Disclosure is required of all transactions between Picture and Frame during the financial period. Picture must disclose details of the leasing transaction and the income of \$5,000 from Frame during the year.

The lease rentals charged comprise 10% of normal market rate. As such, the disclosure note cannot state that the transaction took place on terms equivalent to those in an arm's length transaction.



### Test your understanding 6 – Beth and Banger

Beth and Banger are related parties because the companies are under common control. All transactions between Beth and Banger must be disclosed in the financial statements, as well as any outstanding balances. Beth would not be allowed to disclose that the transactions are at a rate equivalent to those in an arm's length transaction.

Financial statements are important to a range of user groups, such as shareholders, banks, employees and suppliers. These groups rely on the directors to faithfully represent the performance and position of the company. A faithful representation is often presumed to have been provided if accounting standards have been complied with. Therefore, it is essential that the directors adhere to the requirements of IAS 24 *Related Party Disclosures*. The transactions between Beth and Banger will distort the performance and position of both companies and may affect the decisions made by users of the financial statements.

The finance director is required to adhere to the *ACCA Code of Ethics and Conduct*. This sets out the importance of the fundamental principles of confidentiality, objectivity, professional behaviour, integrity, and professional competence and due care.

The finance director's decision breaches several of these principles. Attempting to disguise related party transactions shows a lack of integrity. If such a decision has been motivated by a desire to meet profit targets or to satisfy banks or shareholders, then this demonstrates a lack of objectivity. If the director is unaware of the requirements of IAS 24, then s/he may lack professional competence.



## Adopting new accounting standards

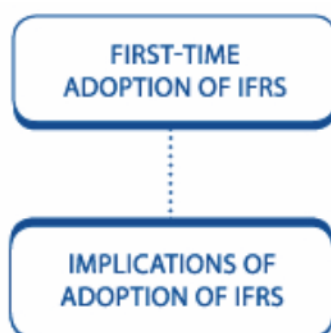
### Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss and apply the accounting implications of the first time adoption of new accounting standards.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



# 1 First time adoption of International Financial Reporting Standards

## Introduction

Although not as significant as they once were, differences remain between IFRS Standards and national standards. Therefore, an accounting issue arises when an entity adopts IFRS Standards for the first time.



### Progression

You will not have studied this topic in earlier ACCA exams.

## IFRS 1 *First Time Adoption of International Financial Reporting Standards*

IFRS 1 *First-time Adoption of International Financial Reporting Standards* sets out the procedures to follow when an entity adopts IFRS Standards in its published financial statements for the first time.

IFRS 1 defines a **first-time adopter** as an entity that, for the first time, makes an explicit and unreserved statement that its annual financial statements comply with IFRS Standards.

There are five issues that need to be addressed when adopting IFRS Standards:

- 1 The date of transition to IFRS Standards
- 2 Which IFRS Standards should be adopted
- 3 How gains or losses arising on adopting IFRS Standards should be accounted for
- 4 The explanations and disclosures to be made in the year of transition
- 5 The exemptions available.

### Date of transition

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The **date of transition** is the '**beginning of the earliest period for which an entity presents full comparative information under IFRS Standards in its first financial statements produced using IFRS Standards**' (IFRS 1, Appendix A).

If an entity adopts IFRS Standards for the first time for the year ended 31 December 20X8 and presents one year of comparative information then the date of transition is 1 January 20X7 (i.e. the first day of the comparative period).

An opening IFRS statement of financial position should be produced as at the date of transition. This statement need not be published, but it will provide the opening balances for the comparative period.

### Which IFRS Standards should be adopted?

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- The entity should use the same accounting policies for all the periods presented. These policies should be based solely on IFRS Standards in force at the reporting date.
- A major problem for entities preparing for the change-over is that IFRS Standards keep changing. Therefore an entity may apply an IFRS Standard that is not yet mandatory if that standard permits early application.
- IFRS 1 states that the opening IFRS statement of financial position must:
  - recognise all assets and liabilities required by IFRS Standards
  - not recognise assets and liabilities not permitted by IFRS Standards
  - reclassify all assets, liabilities and equity components in accordance with IFRS Standards
  - measure all assets and liabilities in accordance with IFRS Standards.
- An entity's estimates at the date of transition to IFRS Standards should be consistent with estimates made for the same date in accordance with previous GAAP unless evidence exists that those estimates were wrong.

### Reporting gains and losses

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Any gains or losses arising on the adoption of IFRS Standards should be recognised directly in retained earnings. They are **not** recognised in profit or loss.



### First-time adoption

On 30 June 20X0, Entity A entered into a derivative contract. Under local GAAP, derivative contracts are unrecognised. The fair value of the derivative was \$1 million on 1 January 20X1.

Entity A will prepare its first financial statements under IFRS Standards for the year ended 31 December 20X2. Its date of transition is therefore 1 January 20X1.

IFRS 9 *Financial Instruments* states that derivatives are measured at fair value. On 1 January 20X1, the derivative would be recognised at \$1 million. Its carrying amount under local GAAP was nil so a gain of \$1 million would be recognised in opening retained earnings.

### Explanations and disclosures

- Entities must explain how the transition to IFRS Standards affects their reported financial performance, financial position and cash flows.
- When preparing its first statements under IFRS Standards, an entity may identify errors made in previous years. The correction of these errors must be disclosed separately.
- When preparing statements in accordance with IFRS Standards for the first time, the fair value of property, plant and equipment, intangible assets and investment properties can be used as the 'deemed cost'. If so, the entity must disclose the aggregate of those fair values and the adjustment made to their carrying amounts under the previous GAAP.

### Exemptions

IFRS 1 grants limited exemptions in situations where the cost of compliance would outweigh the benefits to the user. For example:

- Previous business combinations do not have to be restated.
- An entity can choose to deem past translation gains and losses on an overseas subsidiary to be nil.
- An entity need not restate the borrowing cost component that was capitalised under previous GAAP at the date of transition.



### Test your understanding 1 – Nat

Nat is a company that used to prepare financial statements under local national standards. Their first financial statements produced in accordance with IFRS Standards are for the year ended December 20X5 and these will include comparative information for the previous financial year. Its previous GAAP financial statements are for the years ended 31 December 20X3 and 20X4. The directors are unsure about the following issues:

- (i) Nat received \$5 million in advance orders for a new product on 31 December 20X3. These products were not dispatched until 20X4. In line with its previous GAAP, this \$5m was recognised as revenue.
- (ii) A restructuring provision of \$1 million relating to head office activities was recognised at 31 December 20X3 in accordance with previous GAAP. This does not qualify for recognition as a liability in accordance with IAS 37.
- (iii) Nat made estimates of accrued expenses and provisions at 31 December 20X3. Some of these estimates turned out to be under-stated. Nat believes that the estimates were reasonable and in line with the requirements of both its previous GAAP and IFRS Standards.

**Required:**

**In accordance with IFRS 1, how should the above issues be dealt with?**



### Investor perspective

Entities that have historically prepared their financial statements in accordance with local GAAP are increasingly adopting International Financial Reporting Standards. This is often welcomed by current and potential investors because they seek investments from across the world. The increased adoption of IFRS Standards helps investors to compare the performance and position of an array of different entities, enabling them to make more informed decisions and reducing the risk they are exposed to.

There is a time and cost burden involved when entities adopt a new set of financial reporting standards. However, it is generally believed that this is outweighed by the benefits provided to investors.



### 2 Implications of adopting new accounting standards

Moving from local GAAP to International Financial Reporting Standards requires very careful planning and consideration. However, entities that have accounted under IFRS Standards for many years still need to be aware of the implications of adopting a new accounting standard. After all, the Board regularly revises existing IFRS Standards and issues new IFRS Standards.

Before adopting new accounting standards, an entity should always consider the following:

- **Transitional guidance** – many newly issued accounting standards provide guidance on how to transition from an old accounting standard to a new one (e.g. from IAS 17 *Leases* to IFRS 16 *Leases*). If no guidance is provided, entities should apply IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.
- **Bonuses and performance related pay** – adopting new accounting standards will probably affect profit and, therefore, profit-related bonuses. Such schemes may need to be redesigned.
- **IT systems** – these might not be capable of dealing with the complex recognition, measurement or disclosure requirements of a new accounting standard.
- **Covenants on loans** – key financial statement ratios might deteriorate as a result of implementing a new accounting standard. Loan conditions may need to be renegotiated with the bank to stop borrowings becoming repayable.
- **Earnings per share** – the requirements of a new standard might reduce profit, which will also reduce earnings per share (EPS). EPS is a key financial statement ratio used by potential and current investors.
- **Perception** – analysts may view the move the IFRS Standards, or the early adoption of a newly issued standard, favourably.
- **Knowledge** – the entity may need to spend time and money on training existing staff, or on recruiting new staff.



### 3 Chapter summary

#### First time adoption of IFRS

- Five points to consider are:
  - the date of transition to IFRS
  - which IFRS should be adopted
  - how gains or losses arising on adopting IFRS should be accounted for
  - the explanations and disclosures to be made in the year of transition
  - what exemptions are available



#### Implications of adoption of IFRS

- Consider practical implications – training, IT systems, planning project
- Also consider terms in debt covenants, calculation of performance-related pay and anything that is based on the profit figure
- Communicate with analysts on the expected changes to the financial statements

## Test your understanding answers



### Test your understanding 1 – Nat

Comparative figures prepared under IFRS Standards for year ended 31 December 20X4 must be presented. Nat's date of transition is therefore 1 January 20X4 and an opening IFRS statement of financial position must be produced as at this date.

Some of the accounting policies that Nat uses in its opening IFRS statement of financial position differ from those that it used for the same date using its previous GAAP. The resulting adjustments arise from events and transactions before the date of transition to IFRS Standards. Therefore, Nat should recognise those adjustments directly in retained earnings.

#### Transaction (i)

The sale does not meet the revenue recognition criteria per IFRS 15 *Revenue from Contracts with Customers* because control of the asset has not transferred from the seller to the customer. In the opening IFRS statement of financial position as at 1 January 20X4, a contract liability should be recognised. The \$5 million loss on recognition of this liability will be accounted for in retained earnings.

#### Transaction (ii)

The provision does not meet the criteria in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In the opening IFRS statement of financial position as at 1 January 20X4, the provision should be derecognised. The \$1 million gain on derecognition of this provision will be accounted for in retained earnings.

#### Transaction (iii)

Although some of the accruals and provisions turned out to be underestimates, Nat concluded that its estimates were reasonable and, therefore, no error has occurred. In accordance with IAS 8, this issue should be accounted for prospectively. Therefore the additional expense will be recognised within the profit or loss figures prepared in accordance with IFRS Standards for the year ended 31 December 20X4.

## Small and medium entities

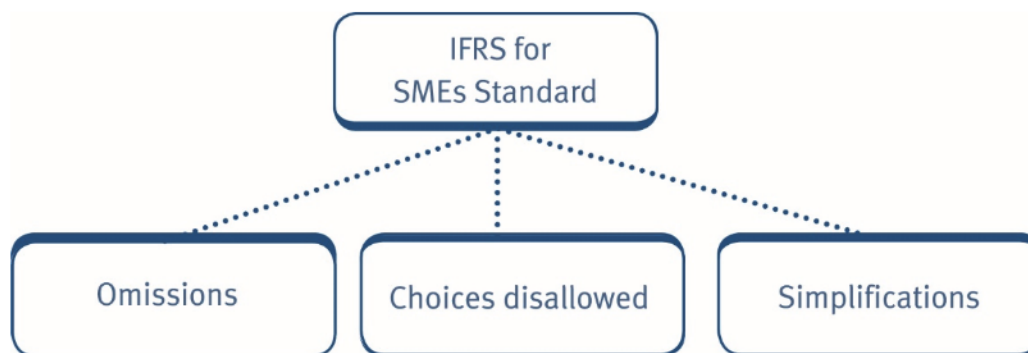
### Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss the key differences in accounting treatment between full International Financial Reporting Standards and the IFRS for SMEs Standard
- Discuss and apply the simplifications introduced by the IFRS for SMEs Standard.



One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.



### Investor perspective

According to the *Conceptual Framework*, the cost and burden of producing financial reporting information for shareholders and other stakeholders should not outweigh the benefits of making that information available.

IFRS for small and medium-sized entities (the SMEs Standard) has been issued for use by entities that have no public accountability. This means that its debt or equity instruments are not publicly traded. The SMEs Standard reduces the burden of producing information that is not likely to be of interest to current or potential investors in a small or medium sized entity.



### Progression

You will not have studied this topic in earlier ACCA exams.

## 1 Small and medium sized entities

### Definition

A small or medium entity may be defined or characterised as follows:

- they are usually owner-managed by a relatively small number of individuals such as a family group, rather than having an extensive ownership base
- they are usually smaller entities in financial terms such as revenues generated and assets and liabilities under the control of the entity they usually have a relatively small number of employees
- they usually undertake less complex or difficult transactions which are normally the focus of a financial reporting standard.